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No. 95-155

Supreme Court, U.S.
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In The

Supreme Court of the United States

October Term, 1995

IN RE WORLDS OF WONDER SECURITIES LITIGATION

DELOITTE & TOUCHE LLP,

Petitioner,

v.

ROSETTA MILLER; WALTER UNTERMEYER; ALAN NISSELSON; TRUDY WHITMAN NISSELSON; PAUL GREENSTEIN; HOWARD H. WESTON, AS TRUSTEE FOR THE FLORIDA MUNICIPAL, INC., RESTATED DEFINED BENEFIT TRUST AND PLAN; and SYLVIA WIND, on behalf of themselves and the certified class of purchasers of the securities of Worlds of Wonder, Inc.,

Respondents.

On Petition For Writ Of Certiorari
To The United States Court Of Appeals
For The Ninth Circuit

BRIEF IN OPPOSITION TO DELOITTE & TOUCHE LLP's PETITION FOR WRIT OF CERTIORARI

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COUNTER-STATEMENT OF QUESTIONS PRESENTED

Can a defendant, sued under Section 11 of the Securities Act, 15 U.S.C. §77k ("Section 11") for disseminating false and misleading statements in the prospectus for a public securities offering, establish the affirmative defense of lack of "loss causation" under Section 11(e) and escape liability for its misstatements – indeed, can the defendant negate the existence of triable issues of fact on the Section 11(e) defense, so as to establish its right to summary judgment – merely by showing that post-offering declines in the price of a security *other* than the security issued in the offering did not result from an *explicit admission* or other *explicit* public disclosure that the statements in the prospectus were false? Is the concept of "loss causation" under Section 11 so narrow that a defendant can defeat liability merely by refusing to admit the falsity of his prior representations?

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STATUTORY PROVISIONS AND RULES INVOLVED

The statutory provisions and rules relevant to the petition for certiorari filed by petitioner Deloitte & Touche LLP are Rule 56 of the Federal Rules of Civil Procedure ("Rule 56") and Section 11(e) of the Securities Act of 1933, 15 U.S.C. §77k(e) ("Section 11(e)"). Rule 56 is reproduced in the Appendix to this Brief, at page App. 1. The relevant portion of Section 11(e) reads as follows:

> The suit authorized under subsection (a) of this section may be to recover such damages as shall represent the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and (1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and the value thereof as of the time such suit was brought: *Provided*, That if the defendant proves that any portion or all of such damages represents other than the depreciation in value of such security resulting from such part of the registration statement, with respect to which his liability is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statements therein not misleading, such portion of or all such damages shall not be recoverable. . . .

COUNTER-STATEMENT OF THE CASE

A. Introduction

Under Section 11 of the Securities Act of 1933, 15 U.S.C. §77k ("Section 11"), an investor who purchases a registered security which is offered pursuant to a misleading prospectus can recover his damages from, *inter alia*, the issuer of the securities, corporate officials who signed the registration statement, and experts, such as auditors, who certified misleading statements in the prospectus. Damages are measured by the difference between the *price paid* for the security on the date of purchase and the *value* of the security on the date of suit (or, if the security was sold before suit was filed, the price at which it was sold).

To prove a Section 11 case, the investor need not show "loss causation" – that is, he need not prove that the misleading prospectus caused his losses. Rather, "loss causation" is presumed, and the *absence* of "loss causation" is an affirmative defense as to which the defendant bears the burden of proof. Thus, under Section 11(e), a defendant can escape liability by showing that the entirety of the plaintiff's injury was due to factors other than the "depreciation in value" of the security resulting from the falsity of the defendant's misrepresentations. 15 U.S.C. §77k(e). The "heavy burden" imposed on defendants by Section 11(e) "reflects Congress' desire to allocate the risk of uncertainty to the defendants in [Section 11] cases." *Akerman v. Oryx Communications*, 810 F.2d 336, 341 (2d Cir. 1987).

Petitioner Deloitte & Touche, LLP ("Deloitte"), a public auditor, falsely certified misleading financial statements which were included in the prospectus for a public

offering of debentures (hereinafter referred to as the "Offering"). Because of the false statements, the *"value"* of the debentures, both at the time of the Offering and on the date the lawsuit was filed, was substantially lower than the price the investors paid for them. Moreover, between the date of the Offering and the date of suit, the *price* of the debentures declined in response to public disclosures which directly related to the reasons why the financial statements had been misleading. However, the misleading financial statements were never restated, and neither the issuer nor Deloitte ever admitted that they were false.

On the foregoing facts, the Ninth Circuit held that Deloitte was not entitled to summary judgment on the affirmative defense of lack of "loss causation" under Section 11(e), reversing the district court's contrary conclusion. *In re Worlds of Wonder Securities Litigation*, 35 F.3d 1407, 1421-23 (9th Cir. 1994) (hereinafter, *"WOW II"*). Deloitte seeks a writ of certiorari to review the Ninth Circuit's ruling. Deloitte urges this Court to rule that a Section 11 defendant who has disseminated materially misleading information in the prospectus for a public securities offering is not liable for his false statements unless, following the Offering, the price of the securities declines in response to an *explicit public admission* or other explicit disclosure that the earlier statements were false. In Deloitte's view, if the only declines in the price of the securities occurred in connection with the disclosure of information which "touched upon" the reasons why the prior statements were misleading, but fell short of an unequivocal admission of their falsity, "loss causation" is lacking as a matter of law and the defendant must be granted summary judgment. Furthermore, Deloitte

argues that a showing that the securities depreciated in *value* (as opposed to *price*) by virtue of the defendants' false statements is insufficient to defeat summary judgment on the issue of "loss causation".

Respondents Rosetta Miller *et al.* (hereinafter, the "Investors") submit this brief in opposition to Deloitte's Petition for Writ of Certiorari. The Investors are themselves seeking a writ of certiorari to review other aspects of the *WOW II* opinion.[1] Nevertheless, the Investors submit that a writ of certiorari should not be granted on the issue identified by Deloitte.

First, the question posed by Deloitte is not fairly presented on this record. The evidentiary showing made by Deloitte in the lower courts would be insufficient to support judgment in its favor even under its interpretation of the statute. Deloitte introduced no evidence below to show the amounts of, timing of, or reasons for any declines in the price or value of the debentures after the Offering. The only evidence Deloitte submitted regarding price movements concerned declines in the price of the issuer's *stock*; but the Investors' Section 11 claims relate only to debentures, not to stock. Furthermore, Deloitte's evidence as to the causes of declines in the stock price was fully rebutted by the Investors below, and even if unrebutted would not be sufficient to support summary judgment even under Deloitte's legal theory. Thus, Deloitte, in essence, is seeking an advisory ruling, which this Court should decline to render.

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[1] *See* Petition for Writ of Certiorari, filed July 25, 1995, in *Miller et al. v. Pezzani et al.*, S. Ct. Dkt. No. 95-154 (hereinafter referred to as the "Investors' Petition").

Second, Deloitte has misrepresented the facts of the case and, in so doing, has inaccurately posed the legal issue which is before this Court on its petition for writ of certiorari. Specifically, Deloitte has erroneously represented in its "Question Presented for Review" that it is an "undisputed fact" that there were no public disclosures between the debenture offering and the date on which Section 11 claims were first filed "regarding" or "relating to" the allegedly erroneous financial statements.[2] This "fact" is disputed, and it is untrue. Expert testimony in the district court established that the announcements that led to the declines in the price of the debentures were directly related to the falsity of the financial statements which appeared in the prospectus for the debenture offering,[3] and the Ninth Circuit found that there was a "direct correlation between the alleged misstatements . . . and the loss. . . . " *WOW II*, 35 F.3d at 1423 n.5. Furthermore, the Investors introduced unrebutted evidence of a direct causal connection between Deloitte's misrepresentations and the depreciation in the *value* of the debentures which independently defeats summary judgment under Section 11(e). Therefore, the factual premise of Deloitte's legal argument – the proposition that it is "undisputed" that the Investors' harm was unrelated to Deloitte's misrepresentations – is simply incorrect. Without that factual premise, the question presented in Deloitte's Petition evaporates.

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[2] *See* Deloitte's Petition for Writ of Certiorari, filed July 25, 1995 (hereinafter cited as "Deloitte Petition"), at page i.

[3] *See* Declaration of John Torkelsen, reproduced in the accompanying Appendix at pages App. 4-App. 35.

Third, there is no conflict among the circuits. Notwithstanding Deloitte's contrary contention, the case of *Akerman v. Oryx Communications, Inc., supra*, does not conflict with the Ninth Circuit's rulings in *WOW II* and does not support the position advocated by Deloitte. Indeed, far from contradicting the opinions of other circuits, the Ninth Circuit's resolution of the "loss causation" issue is consistent with the rulings of all other courts that have addressed the issue. Not a single court, other than the district court whose ruling was reversed in *WOW II*, has ever held that the concept of "loss causation" should be restricted in the extraordinary manner suggested by Deloitte.

Finally, the legal proposition which Deloitte advances is too insubstantial to merit this Court's consideration. Rather, it is demonstrably wrong as a matter of statutory interpretation, public policy and common sense. As the Ninth Circuit held, Deloitte's interpretation of Section 11(e) would eviscerate the statute by permitting wrongdoers who lie in prospectuses to escape all liability simply by refusing to admit that their previous representations were false. *WOW II*, 35 F.3d at 1422. Congress cannot have intended, and did not provide, that the only causal connection which will justify a recovery by defrauded investors under Section 11 is a post-offering price decline triggered by an explicit admission of wrongdoing or a restatement of financial results. The Ninth Circuit's interpretation of Section 11(e) is consistent with the statutory language and the policy underlying the federal securities laws.

B. Factual Background

This investor class action arises out of the collapse of Worlds of Wonder, Inc. ("WOW" or "the Company"), a toy company which sold $80 million of debentures in a public offering on June 4, 1987 (the "Offering"). The Prospectus for the Offering (the "Prospectus") included WOW's audited financial statements for the fiscal year ended March 31, 1987 (hereinafter referred to as "the 1987 fiscal year" or "FY87"), certified by Deloitte as an "expert".

1. WOW's Misleading FY87 Audited Financial Statements

WOW's FY87 audited financial statements reflected favorably on the Company's performance. They represented, *inter alia*, that WOW had recorded net revenues of over $109 million, and had generated a quarterly profit, in the fourth quarter of the 1987 fiscal year ("4Q87"). For the fiscal year as a whole, the financial statements reported record revenues of $327 million and earnings of over $27 million. Accompanying the FY87 audited financial statements in the Prospectus was Deloitte's "unqualified" or "clean" audit opinion, which certified that the financial statements had been presented in accordance with Generally Accepted Accounting Principles ("GAAP"), and that Deloitte had conducted its audit in compliance with Generally Accepted Auditing Standards ("GAAS").

WOW's FY87 financial statements were materially misleading, and Deloitte's audit opinion thereon was

false.[4] The record evidence shows that WOW's financial statements did not conform to GAAP and that Deloitte did not conduct its audit in accordance with GAAS, in at least the following respects, among others:[5]

a. Overstatement of Revenues and Earnings Due to Improper Revenue Recognition

The financial statements significantly overstated WOW's revenues by recognizing revenue on large, irregular transactions at or near the end of FY87. For example, WOW improperly recognized revenue, with Deloitte's approval and assistance, on the "sale" of $18.2 million of merchandise to K-Mart Corporation, the Company's second-largest customer, which purportedly occurred only

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[4] For purposes of its petition for writ of certiorari, Deloitte does not dispute either the falsity of WOW's FY87 financial statements or the inadequacy of its own audit opinion. Rather, Deloitte's posture in this Court is that, assuming *arguendo* that the financial statements and the audit opinion were materially false, Deloitte was nevertheless entitled to summary judgment under Section 11(e) because, as a matter of law, its misrepresentations were not a cause of any injury to the Investors. Both the district court and the Court of Appeals found that there were triable issues of fact regarding the falsity of the financial statements.

[5] The Declaration of accounting and auditing expert witness Albert Rossi, Jr., C.P.A., which was filed in the district court in opposition to the defendants' summary judgment motions, discusses in detail (1) the respects in which WOW's FY87 audited financial statements violated GAAP; (2) Deloitte's failures to conduct its audit in conformity with GAAS; and (3) the amounts of the overstatements caused by these accounting and auditing errors. Mr. Rossi's Declaration, which was document No. 522 of the Excerpts of Record before the Court of Appeals, is reprinted at pages App. 196 through App. 304 of the Appendix to the Investors' Petition in Dkt. No. 95-154.

three days before the end of the fiscal year (hereinafter referred to as the "K-Mart Transaction"). Revenue recognition was improper, among other reasons, because the Letter Agreement which governed the transaction provided that the merchandise would be shipped not to K-Mart but, rather, to a warehouse controlled by WOW, where it would be stored at WOW's expense and risk, and because K-Mart retained rights to return or exchange the merchandise, refuse delivery of it or cancel its order. Thus, under applicable accounting principles and SEC rules, the customer did not have an unconditional obligation to pay for the goods and no completed exchange took place.

WOW also improperly recognized revenue on massive, end-of-fiscal-year transactions with other large customers, including Toys R Us and Walmart (the so-called "FOB and Transfer Sales"), which violated accounting standards for many of the same reasons as the K-Mart Transaction, and on a large transaction under which discontinued products were bartered to media brokers in exchange for discounts on the purchase of future advertising time (the "Barter Deal").

The improper recognition of revenue on the K-Mart Transaction, the FOB and Transfer Sales and the Barter Deal *alone* inflated WOW's reported revenues by over $41 million. Had WOW not recognized revenue on these dubious transactions, the Company would have reported 4Q87 revenues of only $68 million, instead of the $109 million which was actually reported, and would have sustained a quarterly loss of over $17 million. If WOW

had reported results this poor, the Offering could not have gone forward.[6]

b. Other Accounting Errors and Misrepresentations

In addition to the improper recognition of revenues on large, end-of-fiscal-year transactions, WOW's FY87 audited financial statements were deficient and misleading in numerous other respects as well, including, among others, the following:

- **Inventory.** The financial statements understated inventory reserves and overstated assets by failing to adequately account for obsolete inventory and failing to write down overvalued inventory as required by GAAP;
- **Guaranteed Sales, Rights of Exchange and Price Protection.** The financial statements did not disclose or properly account for sales made with guaranteed rights of return, exchange or retroactive price reduction (also called "price protection");
- **Change in Accounting Policies.** The financial statements improperly failed to reveal a material change in accounting policies which inflated WOW's FY87 pretax earnings by approximately $2.5 million.
- **Effect of Large, Questionable Transactions.** The financial statements failed to disclose, as required by GAAP, the significant effect on WOW's revenues in subsequent quarters as a result of the K-Mart, FOB and Transfer Sales; and

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[6] *See* Declaration of Arthur Ainsberg, reproduced in relevant part in the accompanying Appendix beginning on page App. 36, at Paragraphs 25, 27, 117; Declaration of John Torkelsen, at Paragraphs 18, 31, 35-36 (pp. App. 13, 30, 33).

• **Absence of a "Going Concern" Qualification.** Deloitte improperly failed to include in its audit opinion a "going concern" qualification – that is, a warning that the Company's cash resources could be insufficient.

2. The Effect of Deloitte's Misrepresentations on the *Value* of the Debentures

Undisputed expert testimony established that had WOW's financial results been accurately disclosed, the debentures either could not have been sold or would have sold for far less than what the investors paid for them. In other words, as a result of Deloitte's misrepresentations, the *value* of the debentures, both at the time they were offered and at the time of suit, was less than the price at which they were offered to the public. Torkelsen Decl., at Paragraphs 18, 31, 35-36 (App. 13, 30 and 33). Ainsberg Decl., at Paragraphs 25, 27, 117 (App. 48-49, 51). Accordingly, under the language of Section 11, the Investors suffered damages.

3. The Effect of Deloitte's Misrepresentations on the *Price* of the Debentures after the Offering

Beginning almost immediately after the Offering, the price of the debentures declined repeatedly in response to public disclosures of adverse information which, in the words of expert witness John Torkelsen, "directly related" to the reasons why the FY87 audited financial statements had been misleading.[7]

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[7] In connection with the facts recited in this section, *See* Paragraphs 33 and 33(a)-(d) of the Torkelsen Decl., App. 32-34.

- On July 14, 1987, a securities analyst employed by WOW's investment banker, Smith Barney, disseminated a report which stated that WOW's results for the first quarter of its 1988 fiscal year, ending June 30, 1987 ("1Q88") had been disappointing. The report expressly attributed the poor results, *inter alia*, to the effects of the K-Mart, FOB and Transfer Sales at the end of the previous quarter. Thus, the information disclosed in the report "relate[d] directly" to the Investors' allegations that the FY87 financial statements had been misleading due to improper revenue recognition and failure to disclose the effects of the questionable transactions. In response to the report, the prices of WOW securities dropped materially.

- On July 27, 1987, WOW announced its first-quarter earnings, which proved to be at least as disappointing as the Smith Barney analyst had predicted. These results reflected a $2 million reduction from revenue caused by returns of product pursuant to improper "guaranteed sales" arrangements, including the customer's reversal of certain "FOB Sales" to Walmart. The July 27 announcement related directly to the Investors' contentions that revenue recognition on the Walmart sales and other sales with a right of return was improper. Again, the price of WOW securities declined following this announcement.

- On October 16, 1987, WOW announced that in an effort to reduce expenditures, it had laid off 17% of its workforce, including its Chief Financial Officer and its Treasurer – the Company's second major layoff in two months. The layoffs reflected WOW's severe liquidity problems, which, in turn, directly related to Deloitte's failure to include a "going concern" qualification in its audit opinion. In addition, WOW's cash shortage

reflected the Company's prior improper revenue recognition practices, because it was caused in part by customers' refusals to pay for product with respect to which they had rights of return, exchange or "price protection". The prices of WOW securities fell substantially following the October 16 announcement.

• On November 9, 1987, WOW announced that it had suffered losses of $43 million in the quarter ended September 30, 1988 ("2Q88"). Included in the loss figure were "special charges" of $29.75 million, including a $13.2 million reserve for "price protection" and a $12 million reserve for obsolete and overvalued inventory. In addition to the "special charges", WOW wrote off or reserved an additional $20 million to reflect returns of product relating to sales with a right of return. Even more significantly, the 2Q88 results reflected the reversal of $9.9 million of revenue due to K-Mart's cancellation of a portion of the K-Mart Transaction – a cancellation attributable in relevant part to K-Mart's exercise of the very same rights of cancellation and product exchange which were among the factors that had rendered the initial recognition of revenue on the transaction improper.[8] The November 9 announcement directly related to the Investors' contention that the FY87 financial statements were misleading in failing to account properly for "price protection"; in not establishing sufficient inventory reserves; and in recognizing revenue on sales with "guaranteed"

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[8] The initial K-Mart transaction included the "sale" to K-Mart of substantial quantities of WOW's two principal products – 200,000 "Lazer Tag" kits and 80,000 "Teddy Ruxpin" bears. As a result of the cancellation, K-Mart never took delivery of *any* of the Lazer Tags, and accepted only 30,000 of the 80,000 Teddy Ruxpins.

rights of return or exchange. Furthermore, this disclosure obviously related closely to the reasons why the recognition of revenue on the K-Mart Transaction had been improper. The price of WOW securities again fell significantly following the November 9 announcement.

4. WOW's Bankruptcy

On December 21, 1987, WOW declared bankruptcy, without having made even the first of 50 scheduled semi-annual interest payments on the debentures. For the quarter ended December 31, 1987, WOW recorded special reserves and write-offs totaling $89 million, mostly for "price protection", overvalued inventories and uncollectible receivables. Even after these charges were taken, experts brought in by the creditors to try to salvage WOW's assets concluded that only $26 million of the $77-$84 million of receivables on the Company's books were collectible.

5. The Class Action

On December 7, 1987, investor/respondent Rosetta Miller filed the first Section 11 claims against Deloitte and certain other defendants, based, *inter alia*, on the inclusion of misleading financial statements and Deloitte's false audit opinion thereon in the prospectus for the debenture Offering. The claims asserted by Miller and a subsequent Section 11 claimant, investor/respondent Howard Weston, Trustee, were consolidated with actions against Deloitte and other defendants based on other provisions of law. The district court certified the plaintiff class in the consolidated cases by order dated March 23, 1990.

On January 20, 1993, the district court granted summary judgment in Deloitte's favor on the Section 11 claims, holding that Deloitte had established, as a matter of law, the defense of lack of "loss causation". The court concluded that Deloitte's misrepresentations had not caused any loss by the Investors, and that there were no triable issues of fact with respect to the "loss causation" issue, because the post-Offering declines in the price of the debentures were not triggered by an explicit public disclosure that the FY87 audited financial statements or Deloitte's audit opinion thereon had been false. *In re Worlds of Wonder Securities Litigation*, 814 F. Supp. 850, 866-67, 876 (N.D.Cal. 1993) ("*WOW I*").

C. The Ninth Circuit's Opinion

The Ninth Circuit Court of Appeals reversed the district court's grant of summary judgment in Deloitte's favor on the Section 11 claims, holding that the district court's "loss causation" analysis had been based on the "faulty premise" that the falsity of Deloitte's alleged misrepresentations was required to be explicitly disclosed to the market before Section 11 liability could attach. *WOW II*, 35 F.3d at 1422. The Court held that the district court's analysis of "loss causation" was "far too narrow". It stated:

> [T]he district court's interpretation would eviscerate the statute. Companies and their auditors could immunize themselves from § 11 liability for false and even fraudulent financial statements simply by refusing to admit their falsity (or refusing to include in their adverse public disclosures information that would clue in the market to their falsity) prior to the time a § 11 suit is filed.

WOW II, 35 F.3d at 1422 (internal quotation marks deleted).

Rejecting the district court's narrow test, the Ninth Circuit held that "loss causation" exists under Section 11 whenever "the misrepresentation *touches upon* the *reasons* for the investment's decline in value." *Id.* (emphasis in original). The Court analyzed the disclosures which had caused the price of the debentures to decline after the Offering and concluded that there was a "direct correlation between the alleged misstatements . . . and the loss . . . [which] is sufficient to nullify Deloitte's 'loss causation' defense on summary judgment." *WOW II*, 35 F.3d at 1423 n.5.

Because it found that the evidence of causation with respect to declines in the *price* of the debentures was so persuasive, the Court did not reach the issue of whether plaintiffs' evidence that Deloitte's misrepresentations had caused the *value* of the debentures to decline would defeat a Section 11(e) defense. Nevertheless, the Court suggested in *dicta* that "the plain statutory language" appeared to support the Investors' contention that such evidence would be sufficient to establish "loss causation". *WOW II*, 35 F.3d at 1423 n.6.

ARGUMENT

REASONS FOR DENYING THE WRIT

A. The Issue On Which Deloitte Seeks A Writ of Certiorari Is Not Fairly Presented On This Record

Deloitte's Petition for a writ of certiorari to review the Ninth Circuit's ruling on the issue of "loss causation" under Section 11(e) should be denied because the issue

on which Deloitte seeks review is not fairly presented on this record. Specifically, the evidence introduced by Deloitte below would have been insufficient to merit summary judgment even under the erroneous interpretation of Section 11(e) which Deloitte has urged this Court to adopt. Thus, the legal question which Deloitte presents does not arise on this record.

To prevail on its Section 11(e) defense at trial, even under its own faulty interpretation of the statute, Deloitte was required to demonstrate that declines in the price of the debentures from the date of the Offering through the date the Section 11 claims were filed resulted from factors other than explicit disclosures that the FY87 audited financial statements, and Deloitte's "clean" audit opinion thereon, had been false. To obtain *summary judgment* under its interpretation of Section 11(e), Deloitte's burden was even heavier – it was required to bear the burden of negating the existence of any triable issues of fact regarding the causation of the Investors' losses. However, Deloitte failed to meet this burden.

First, Deloitte introduced no evidence regarding the price of the debentures, any declines in the price of the debentures or the reasons for such declines. Thus, the declaration of expert witness Robert Stillman, the sole evidence Deloitte presented in support of its summary judgment motion on the "loss causation" issue, expressed opinions only regarding movements in the price of Worlds of Wonder's *stock* and the disclosures affecting the *stock price*, and was silent as to the fact of or reasons

for any movements in the price of the debentures.[9] Moreover, Stillman's opinion regarding the causes of stock price movements did not even purport to cover the entire period during which, under Deloitte's theory, damages were potentially accruing – that is, the period from the date of the Offering through December 7, 1987, the date the Section 11 claims were first filed. Rather, Stillman's opinion covered *only* the period from the date of the Offering through November 9, 1987 – one month *before* the Section 11 claims were filed. Thus, it did not even attempt to negate causation for all damages suffered by the debenture investors. Therefore, Deloitte failed to meet its evidentiary burden on summary judgment under the interpretation of Section 11 which it has urged on this Court.

Furthermore, Deloitte has misrepresented the factual record regarding the nature of the disclosures which led to declines in the debenture price. In reliance on the Stillman Declaration, Deloitte has argued that it is "undisputed" that there were no disclosures after the date of the Offering "regarding the allegedly erroneous financial statements" (Deloitte Petition at i); and that it is similarly "undisputed" that the decline in the prices of WOW's debentures from the date of the Offering through the date suit was filed were all triggered by public announcements "regarding" events that occurred after the close of the fiscal year to which the false financial statements related. *Id.*

However, as the Ninth Circuit found, both of these supposedly "unrebutted" factual contentions which form

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[9] *See* Declaration of Robert Stillman, reproduced in the Appendix (exclusive of exhibits) beginning at App. 56.

the basis for Deloitte's legal argument were, in fact, *rebutted* by the Investors. Thus, the Investors introduced expert testimony below proving that the disclosures which led to declines in the price of the debentures after the Offering *"directly related"* to the Investors' allegations regarding the falsity of the financial statements. *See, e.g.*, Torkelsen Declaration, Paragraphs 33 (a)-(d) and 34, App. 30-32. *WOW II*, 35 F.3d at 1422-23. That testimony formed the basis for the Ninth Circuit's finding that there was a "direct correlation between the alleged misstatements . . . and the loss." *WOW II*, 35 F.3d at 1422 n.5.

Thus, due to the inadequacy of the evidentiary showing it made below and the rebuttal evidence submitted by the Investors, Deloitte could not obtain summary judgment even under the legal standard which it is urging this Court to adopt. Accordingly, Deloitte, in essence, is seeking an advisory ruling which, we submit, this Court should decline to render.

Therefore, Deloitte's Petition for a Writ of Certiorari should be denied.

B. The Ninth Circuit's Decision in *WOW II* Does Not Conflict with the Second Circuit's Decision in *Akerman v. Oryx Communications, Inc.*

Deloitte's contention that the Ninth Circuit's decision in this case conflicts with the Second Circuit's decision in *Akerman v. Oryx Communications, Inc., supra*, is completely without merit. *Akerman* is factually distinguishable from this case, and does not even discuss the legal issue raised by Deloitte.

Deloitte's contention herein is that a Section 11 plaintiff cannot rebut the defense of lack of "loss causation" under Section 11(e) by showing that the price of the

securities declined after he purchased them in response to public disclosures which merely "touch upon", or directly relate to, the reasons why the prospectus disclosures were misleading. According to Deloitte, "loss causation" is absent unless the price of the securities declines in response to an *explicit disclosure* that the prior representations were false. In *Akerman*, however, the defendants *did* expressly disclose after the offering that the financial statements in the offering prospectus had been false. Thus, the question of whether "loss causation" can be satisfied by a price decline triggered by something less than an explicit disclosure of the falsity of prior statements – the question raised by Deloitte in its Petition for Certiorari – never arose.

Thus, there is no conflict between the *Akerman* court's *dictum* that "the price decline before disclosure may not be charged to the defendants" (810 F.2d at 342) and the Ninth Circuit's decision herein. Nothing in the *Akerman* court's statement, or in the *Akerman* opinion as a whole, is inconsistent with the Ninth Circuit's holding that a price decline triggered by something less than an explicit admission of the falsity of previous statements can defeat a section 11(e) defense.

Akerman does not say that there must be an explicit disclosure that previous statements were false before liability will attach. Indeed, *Akerman* expresses no view regarding *what sort* of disclosure is necessary to trigger "loss causation". Thus, *Akerman* is as consistent with the Ninth Circuit's theory of "loss causation" as it is with Deloitte's.[10]

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[10] The issue in *Akerman* was quite different from the issue raised by Deloitte herein. In *Akerman*, summary judgment was

C. Deloitte's Interpretation of Section 11(e) Does Not Merit Review By This Court

Finally, the interpretation of Section 11(e) which Deloitte urges on this Court is so indefensible as a matter of statutory interpretation, and so at odds with the weight of authority, public policy and common sense, that it does not merit consideration by this Court.

1. Deloitte's Interpretation of the Statute Produces Absurd Results Which Contradict the Purpose and Policy of the Securities Act

As this Court held in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976):

> The Securities Act of 1933 . . . was designed to provide investors with full disclosure of material information concerning public offerings of securities in commerce, to protect investors against fraud and, through the imposition of specified civil liabilities, to promote ethical standards of honesty and fair dealing.

To that end, Section 11 of the Act imposes "a stringent standard of liability" on defendants who promulgate misleading statements in prospectuses for public offerings and places a correspondingly "minimal" burden on plaintiffs. *Herman & MacLean v. Huddleston*, 459 U.S. 375, 381 (1983). For example, liability against the issuer is

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granted to the defendants because the misrepresentations in the prospectus were "barely material", and the price of the securities went up, not down, when the truth was disclosed. *Akerman*, 810 F.2d at 342-43. Here, even Deloitte does not argue that the errors in the financial statements were immaterial, and it is undisputed that the price of the debentures went down when adverse disclosures related thereto were made. Therefore, *Akerman* is distinguishable from this case.

virtually absolute, even for innocent misstatements, while auditors and other "experts" who falsely certify misleading materials in prospectuses must bear the burden of demonstrating that they were not negligent to escape liability. *Hochfelder*, 425 U.S. at 208. Similarly, in shifting the burden to the defendants on the issue of "loss causation", Section 11(e) amounts to a *presumption* of causation in favor the plaintiffs. *In re Fortune Systems Securities Litigation*, 680 F. Supp. 1360, 1364 (N.D.Cal. 1987)[11].

Congress intended the burden of disproving "loss causation" to be a "heavy" one[12], available only where the investors' harm was caused by market forces or other factors unrelated to the defendant's misrepresentations.[13] Yet, under the interpretation of Section 11(e) proffered by Deloitte, defendants would be able to disprove "loss causation" in nearly every case. It is a truism that "[c]ases in which a company announces 'A' and then strictly 'A is not true' are rare." B. Cornell and R. G. Morgan, *Using Finance Theory to Measure Damages in Fraud on the Market Cases*, 37 U.C.L.A. L. Rev. 883, 891 (1990). Only in such a

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[11] Deloitte's contention that it is the policy of this Court to interpret the federal securities laws narrowly, and to restrict investor protection thereunder, is wrong. To the contrary, this Court has repeatedly held that the federal securities statutes "should be construed not technically and restrictively but flexibly to effectuate their remedial purpose." *Herman & MacLean v. Huddleston*, 459 U.S. at 386-87.

[12] *Akerman*, 810 F.2d at 341; *Fortune Systems*, 680 F. Supp. at 1364.

[13] *See, e.g., Fortune Systems*, 680 F. Supp. at 1364; *Feit v. Leasco Data Processing Equipment Corp.*, 332 F. Supp. 544, 586 (E.D.N.Y. 1971); *Fox v. Glickman Corp.*, 253 F. Supp. 1005 (S.D.N.Y. 1966).

"rare" case would a Section 11 plaintiff escape summary judgment under Deloitte's interpretation of Section 11(e).

Indeed, if Deloitte's view of the statute were correct, a dishonest issuer or a negligent auditor could affirmatively prevent a Section 11 case from ever being brought, simply by refusing to acknowledge that prior representations were false. Such a result not only contradicts the purpose and policy behind the statute but also defies common sense. This consideration led the Ninth Circuit to conclude, correctly, that if Deloitte's interpretation of Section 11(e) were adopted, it would "eviscerate the statute." *WOW II*, 35 F.3d at 1422.

2. Deloitte's Interpretation Is Clearly and Demonstrably Inconsistent with the Express Language of Section 11(e)

Deloitte's interpretation of Section 11(e) is not only out of harmony with the *policy* of the federal securities laws – it is inconsistent with the *language* of the statute. Section 11 provides no support whatsoever for Deloitte's interpretation of Section 11(e). Indeed, to arrive at such an interpretation, one would have to misread the statutory language in at least two distinct ways.

Misinterpretation No. 1: Section 11's Use of the Terms "Value" and "Depreciation in Value", Should Be Ignored; "Value" is Synonymous with "Price"

To interpret Section 11(e) as Deloitte has done, one must first ignore the statutory measure of damages and adopt a damage measure which is not in the statute. In its Petition, Deloitte glosses over the relationship between the statutory measure of damages and the concept of "loss causation". However, the two issues are inter-

related: Under Section 11(e), a defendant can obtain summary judgment on the grounds of lack of "loss causation" only by showing that all of the damages suffered by the plaintiff were caused entirely by something other than his misconduct.

Deloitte's entire argument is predicated on an interpretation of the statutory damages formula language which is incorrect. Specifically, Deloitte's argument stands or falls on its contention that "the statutory measure of damages under Section 11 is the difference between the *price* of a security at two distinct points in time (the time of purchase and the time of sale or suit)". Deloitte Petition at 4. But the statute does not say that. Rather, the statute provides that Section 11 damages for a security which the investor continues to hold on the date of suit are equal to the difference between the price paid at the time of purchase and the ***value*** of the security at the time of suit.

That "price" and "value" are distinct concepts is surely not a novel conception – for generations, the "out of pocket" measure of damages in a common-law fraud or Rule 10b-5 case has been computed by measuring the "artificial price inflation" caused by the fraud – *i.e.*, the price paid for the security minus the "true value" of the security at the time of purchase.[14]

As is explained in the seminal case of *Beecher v. Able*, 435 F. Supp. 397, 410 n.5 (S.D.N.Y. 1975), the statutory damage measure set forth in Section 11 is a modified

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[14] *See, e.g., Wool v. Tandem Computers*, 818 F.2d 1433, 1437 (9th Cir. 1987); *Green v. Occidental Petroleum Corp.*, 541 F.2d 1335, 1341-46 (9th Cir. 1976) (Sneed, J. concurring); *In re Washington Public Power Supply System Sec. Lit.*, 650 F. Supp. 1346 (W.D.Wash. 1986)

form of the "out of pocket" measure applicable in fraud cases – instead of the purchase price of the security minus the true value *at the time of purchase*, Section 11 damages are equal to the purchase price of the security minus its "true value" *at the time of suit*, with some additional modifications to prevent the plaintiff from achieving a double recovery by selling his securities early at a higher price or benefiting from a subsequent increase in their price after suit is filed.

Cases interpreting Section 11 have recognized that while "price" may be *evidence* of "value", and a decline in price may be *evidence* of a depreciation in value, the two terms are not synonymous. Thus, in *Beecher v. Able, supra*, the Court stated:

> [V]alue [under Section 11] may be something other than market price, where the public is either misinformed or uninformed about important factors relating to the defendant-offeror's well-being. Moreover, the conclusion that "value" is not synonymous with market price seems clearly dictated by the plain language of section 11(e) in which both "price" (sometimes "amount paid") and "value" are used, apparently deliberately, to connote different concepts.[15]

In computing Section 11 damages in *Beecher*, the Court concluded that the "value" of the securities at the time of suit was different from their price.

Thus, to meet its burden under Section 11(e), Deloitte was required to show that the entirety of the plaintiff's harm was attributable to factors other than the *depreciation in value* – not "decline in price" – of the security

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[15] *Beecher v. Able*, 435 F. Supp. at 404-05. *Accord Grossman v. Waste Management, Inc.*, 589 F. Supp. 395 (N.D.Ill. 1984).

resulting from the misrepresentations. As the Ninth Circuit recognized, this is what the plain language of Section 11(e) provides. *WOW II*, 35 F.3d at 1423 n.6.

Under the true statutory damage formula, the legal contention in Deloitte's Petition does not even arise. Because the value of the debentures was not necessarily equal to their market price at the time of suit, Deloitte could not negate "loss causation" merely by pairing corrective disclosures with declines in the *price* of the debentures. Rather, Deloitte would have had to show that its misrepresentations did not cause any depreciation in the *value* of the debentures. It is undisputed that Deloitte made no such showing.

In short, because Deloitte's interpretation is clearly inconsistent with the language of the statute, granting review to consider that interpretation would be an inappropriate expenditure of this Court's time and resources.

Misinterpretation No. 2: Causation Can Be Proved Only By Showing a Price Decline Attributable to an Explicit Admission that the Misrepresentations Were False

Assuming, *arguendo*, that Deloitte has correctly characterized the statutory damages formula under Section 11 – that is, assuming that Section 11 damages are equal to "the price paid minus the *price* at time of suit", instead of "the price paid minus the *value* at time of suit" – Deloitte's interpretation of the affirmative defense of lack of "loss causation" under Section 11(e) is nevertheless demonstrably and clearly wrong. Section 11(e) provides no support whatsoever for Deloitte's contention that "loss causation" exists only where there is a decline in price triggered by an explicit admission or other explicit acknowledgment of the falsity of a prior statement, and that price declines which follow announcements that "touch upon" or "directly relate to" the

reasons why the prospectus representations were false cannot establish "loss causation".

Nothing in the statute supports this revolutionary restriction on the concept of causation. Deloitte points to the statutory language that "loss causation" is absent where the plaintiff's damages are attributable to factors other than the depreciation in value of the securities *"resulting from"* the falsity of the prospectus misrepresentations. However, Deloitte does not and cannot explain why the "resulting from" language merits the unduly restrictive interpretation which Deloitte has placed on it.

No court (other than the district court below) has ever adopted the exceedingly narrow interpretation of "loss causation" under Section 11(e) advanced by Deloitte.[16] Indeed, other cases decided under Section 11(e) have come to precisely the opposite conclusion. Thus, in *Fortune Systems, supra,* the Court explicitly held that "loss causation" can be proved by showing that the price of the securities declined in response to disclosures which "touch upon" the reasons why the prospectus representations were false.[17] Furthermore, numerous cases

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[16] None of the cases cited by Deloitte (Deloitte Petition at 11-12, 13) hold that only a price decline triggered by an explicit admission of the falsity of a prior statement will establish "loss causation". Indeed, *McMahan v. Wherehouse Entertainment,* 859 F. Supp. 743, 751 (S.D.N.Y. 1994), holds that there can be "loss causation" under Section 11 without any disclosure at all, based solely on the effects of the defendants's fraud on the value of the securities in question. *Akerman, supra,* and *Lyne v. Arthur Andersen & Co.,* 772 F. Supp. 1064 (N.D.Ill. 1991), simply do not address the issue.

[17] *Fortune Systems,* 680 F. Supp. at 1365. *See Westinghouse Elec. Corp. v. 21 International Holdings, Inc.,* 821 F. Supp. 212 (S.D.N.Y. 1993) (triable issues held to exist under Section 11(e)

decided under Section 10(b) of the Securities Exchange Act of 1934 ("Section 10(b)") have held that "loss causation" can be proved by showing price declines that "touch upon" the reasons why the defendants' misrepresentations were false.[18]

Deloitte argues that it is improper to cite cases decided under Section 10(b) in interpreting the proper standard of "loss causation" under Section 11(e). However, the Ninth Circuit's interpretation of "loss causation" is not dependent solely on Section 10(b) cases. *See* n. 17, *supra*. Moreover, Deloitte is wrong in arguing that Section 10(b) cases can provide no guidance on this issue. As this Court has held, the 1933 and 1934 Acts "constitute interrelated elements of the federal regulatory scheme governing transactions in securities." *Hochfelder*, 425 U.S. at 206. Accordingly, they must be construed "cumulatively". *Huddleston*, 459 U.S. at 386. The concept of causation is the same under both statutes; only the allocation of the burden of proof and the mechanics of the damage calculation differ.

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even though the disclosure which caused the price drop was not an explicit acknowledgement of the falsity of an earlier prospectus statement); *Beecher v. Able*, *supra* (announcement of third-quarter losses was sufficiently related to defendant's failure to disclose the misleading nature of prospectus to show "loss causation"); *Walco Investments, Inc. v. Thenen*, 881 F. Supp. 1576, 1584 (S.D.Fla. 1995) ("loss causation" may be satisfied by showing that offering would not have gone forward but for defendants' misrepresentations).

[18] *See, e.g., McGonigle v. Combs*, 968 F.2d 810, 821 (9th Cir.), *cert. dismissed*, ___U.S.___, 113 S.Ct. 399 (1992); *Arthur Young & Co. v. Reves*, 937 F.2d 1310 (8th Cir. 1991), *cert. denied*, ___ U.S. ___, 112 S.Ct. 1165 (1992).

Indeed, there is nothing mystical or arcane about the concept of "loss causation". As the Ninth Circuit pointed out, "loss causation" under *both* Section 11 and Section 10(b) is simply proximate causation.[19] To prove proximate causation in a tort case, there need only be a "reasonable connection" between the act or omission of the defendant and the damage that the plaintiff suffered. W. Keeton, D. Dobbs, R. Keeton, D. Owen, *Prosser and Keeton on Torts*, § 41 at 263 (5th ed. 1984). Similarly, under both Section 10(b) and Section 11(e), "loss causation" is present where there is a "reasonable connection" between the wrong and the harm. The legal theory advocated by Deloitte is inconsistent with this simple rule, and cannot be justified under any reasonable reading of the statute.

In seeking to persuade this Court that the Ninth Circuit has opened up Pandora's box, Deloitte conjures up a vision of a "touches upon" test in which the mere fact that the misrepresentation and the harm coincidentally relate to similar subject matters would establish "loss causation". Deloitte suggests that such a test would expose defendants to widely expanded, and unjustifiable, liability. However, in so arguing, Deloitte mischaracterizes the Ninth Circuit's ruling. The Ninth Circuit held that "loss causation" exists where the misrepresentation touches upon the *reasons* for the investment's decline in value. *WOW II*, 35 F.3d at 1422. The Court did not hold

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[19] *WOW II*, 35 F.3d at 1422; *Fortune Systems*, 680 F. Supp. at 1364-65 (interpreting "loss causation" under Section 11); *Securities Investor Protection Corp. v. Vigman*, 908 F.2d 1461, 1468 (9th Cir. 1990), *rev'd on other grds*, 503 U.S. 261 (1992) ("loss causation" under Section 10(b)); *Manufacturers Hanover Trust Co. v. Drysdale Sec. Corp.*, 801 F.2d 13, 21-22 (2d Cir. 1986), *cert. denied*, 479 U.S. 1066 (1987) (Section 10(b)).

that causation can be based on a merely coincidental or fortuitous similarity of subject matters between the loss and the harm. Thus, the "touches upon" test attacked by Deloitte is a straw man. The Ninth Circuit's holding is fully consistent with both the language and policy of the statute and the rulings of other courts.

CONCLUSION

For the foregoing reasons, this Court should deny Deloitte's petition for a writ of certiorari.

Respectfully submitted,

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APPENDIX

Fed.R.Civ.P. Rule 56. Summary Judgment

(a) For Claimant. A party seeking to recover upon a claim, counterclaim, or cross-claim or to obtain a declaratory judgment may, at any time after the expiration of 20 days from the commencement of the action or after service of a motion for summary judgment by the adverse party, move with or without supporting affidavits for a summary judgment in the party's favor upon all or any part thereof.

(b) For Defending Party. A party against whom a claim, counterclaim, or cross-claim is asserted or a declaratory judgment is sought may, at any time, move with or without supporting affidavits for a summary judgment in the party's favor as to all or any part thereof.

(c) Motion and Proceedings Thereon. The motion shall be served at least 10 days before the time fixed for the hearing. The adverse party prior to the day of hearing may serve opposing affidavits. The judgment sought shall be rendered forthwith if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law. A summary judgment, interlocutory in character, may be rendered on the issue of liability alone although there is a genuine issue as to the amount of damages.

(d) Case Not Fully Adjudicated on Motion. If on motion under this rule judgment is not rendered upon the whole case or for all the relief asked and a trial is necessary, the court at the hearing of the motion, by examining

the pleadings and the evidence before it and by interrogating counsel, shall if practicable ascertain what material facts exist without substantial controversy and what material facts are actually and in good faith controverted. It shall thereupon make an order specifying the facts that appear without substantial controversy, including the extent to which the amount of damages or other relief is not in controversy, and directing such further proceedings in the action as are just. Upon the trial of the action the facts so specified shall be deemed established, and the trial shall be conducted accordingly.

(e) Form of Affidavits; Further Testimony; Defense Required. Supporting and opposing affidavits shall be made on personal knowledge, shall set forth such facts as would be admissible in evidence, and shall show affirmatively that the affiant is competent to testify to the matters stated therein. Sworn or certified copies of all papers or parts thereof referred to in an affidavit shall be attached thereto or served therewith. The court may permit affidavits to be supplemented or opposed by depositions, answers to interrogatories, or further affidavits. When a motion for summary judgment is made and supported as provided in this rule, an adverse party may not rest upon the mere allegations or denials of the adverse party's pleading, but the adverse party's response, by affidavits or as otherwise provided in this rule, must set forth specific facts showing that there is a genuine issue for trial. If the adverse party does not so respond, summary judgment, if appropriate, shall be entered against the adverse party.

(f) When Affidavits are Unavailable. Should it appear from the affidavits of a party opposing the motion

that the party cannot for reasons stated present by affidavit facts essential to justify the party's opposition, the court may refuse the application for judgment or may order a continuance to permit affidavits to be obtained or depositions to be taken or discovery to be had or may make such other order as is just.

(g) Affidavits Made in Bad Faith. Should it appear to the satisfaction of the court at any time that any of the affidavits presented pursuant to this rule are presented in bad faith or solely for the purpose of delay, the court shall forthwith order the party employing them to pay to the other party the amount of the reasonable expenses which the filing of the affidavits caused the other party to incur, including reasonable attorney's fees, and any offending party or attorney may be adjudged guilty of contempt.

UNITED STATES DISTRICT COURT

NORTHERN DISTRICT OF CALIFORNIA

IN RE WORLDS OF WONDER SECURITIES LITIGATION	Case No. C-87-5491 SC (Filed Oct. 27, 1992) DECLARATION OF JOHN B. TORKELSEN IN SUPPORT OF PLAINTIFFS' RESPONSE TO DEFENDANTS' MOTIONS FOR SUMMARY JUDGMENT
This Document Relates To: ALL ACTIONS.	Date: December 11, 1992 Time: 10:00am Place: Courtroom of the Honorable Samuel J. Conti

I, JOHN B. TORKELSEN, hereby declare and state as follows:

1. I am President of Princeton Venture Research, Inc. which has offices at Five Vaughn Drive, Princeton, New Jersey 08540 and 401 B Street, San Diego, California 92101. I am the principal individual who performed work on the Worlds of Wonder, Inc. ("WOW") litigation. In addition, I was responsible for the supervision of the other employees of Princeton Venture Research who worked on this engagement. I was assisted in my efforts by Ms. Candace Preston, CFA and Ms. Cynthia Jones, CFA as well as other associates of the firm in preparing various materials and performing research.

2. As President of Princeton Venture Research, Inc. ("PVR"), a company composed of professional securities and financial analysts, I provide and supervise fundamental analysis of individual stocks and selected industries to institutional investors such as major banks, insurance companies, mutual funds, pension funds and university endowments in the United States and Europe. A copy of my resume has been included as Exhibit A..

3. In addition, PVR provides financial analysis, investment banking services and venture capital consulting to corporate clients in the United States and Europe.

4. I have earned the following professional titles:

A. Chartered Financial Analyst;

B. Registered Supervisory Analyst New York Stock Exchange; and

C. Registered NASD General Securities Principal.

5. In connection with my association with the securities industry, I have researched, prepared, and published hundreds of reports analyzing individual companies and whole industry segments. These reports have been widely distributed among institutional and other investors.

6. I have been retained as an expert witness and to assist in investigations in a number of civil cases involving alleged securities law violations. I have testified on more than 20 occasions and have previously qualified as an expert witness with regard to matters similar to those at issue in this litigation, including, without limitation, matters related to financial markets, disclosure issues,

materiality, causation, and damages, both in the Federal courts in this district and elsewhere.

OVERVIEW OF ASSIGNMENT

7. Counsel for plaintiffs has requested that I review the Declaration Of Randolph Westerfield In Support of Defendants' Motion For Summary Judgment (the "Westerfield Declaration") and the Declaration Of Robert Stillman In Support Of Deloitte And Touche's Motion For Summary Judgment, Or Alternatively For Summary Adjudication Of Claims (the "Stillman Declaration"). I have been asked by plaintiffs' counsel to address the question of whether the facts alleged by plaintiffs to have been misrepresented and/or undisclosed by defendants would have been viewed as significant by a reasonable investor in Worlds of Wonder, Inc.'s common stock and convertible subordinated debentures and whether timely disclosure of such facts would have caused a decline in the prices of WOW's securities at an earlier point during the Class Period. I have also been asked by plaintiffs' counsel to address the following opinions set forth in the Westerfield Declaration:

A. That the misfortunes that caused WOW's stock price to drop were either unforeseeable or materializations of risks with which the market was familiar;

B. That WOW's statements about its business operations and prospects adequately warned investors of the risks that WOW faced; and

C. That there is no evidence of material stock price movements associated with allegedly misleading or omitted information.

8. I was also asked to address the following opinions set forth in the Stillman Declaration:

A. That there was no correlation between any significant negative returns on WOW common stock and any new information relating to WOW's financial statements for the fiscal year ended March 31, 1987.

9. My opinion is rendered on the basis of my professional experience, as well as my review of documents including:

A. the public filings of WOW including Reports on Form 10-K and 10-Q, Proxy Statements, and Quarterly and Annual Reports to Shareholders;

B. the June 20, 1986 Prospectus and the June 4, 1987 Prospectus;

C. Company issued press releases;

D. securities analysts' reports concerning WOW and the industry in which it operated;

E. contemporaneous news articles relating to WOW and the industry in which it operated which appeared in the financial, business and general press;

F. price and volume data of WOW's common stock for the relevant time period and monthly price and volume data for WOW's convertible subordinated debentures;

G. stock price indices for the relevant time period as well as stock prices for WOW's peers in the toy industry;

H. *Vickers Stock Traders Guide ("Vickers")*,[1] reported compilation of securities holdings;

I. the Third Amended Consolidated Class action complaint;

J. other documents produced in the course of this litigation.

10. It is my understanding that plaintiffs in this action allege that defendants misrepresented material facts or omitted to state material facts in documents and statements disseminated during the Class Period with regard to the following matters, among others:

A. Defendants falsely represented that the product return rate of the Teddy Ruxpin line had declined to below average levels when, in fact, quality control problems remained on-going and return rates were above average.

B. The Company lacked adequate accounting, financial, management, production, and inventory controls.

C. Net sales and earnings were inflated due to violations of Generally Accepted Accounting Principles in connection with WOW's financial statements for the fiscal years ended March 31, 1986 and 1987, and the quarter ended December 31, 1986; and the audits of WOW's financial statements made by WOW's auditor,

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[1] A service widely used in the investment community which reports institutional stock holdings as reported at the end of each calendar quarter.

Deloitte Haskins & Sells, were not made in accordance with Generally Accepted Auditing Standards.

D. Defendants' public predictions that WOW would achieve over $300 million in sales for the fiscal year ended March 31, 1987 and $500 million in the following fiscal year had no reasonable basis because of adverse conditions affecting the Company; the significant lack of internal controls; improper sales transactions with deferred payment terms; the uncollectibility of accounts receivable; customer rights of return and price protection; and the inadequacy of WOW's capital resources.

E. Defendants failed to disclose prior to the June 1987 debenture offering that the market for certain WOW products, including the Lazer Tag product line, described in the 1987 Prospectus as the most successful WOW product launched in fiscal 1987, had declined dramatically; that retailer inventories of Lazer Tag and other WOW products were high and customer sell-through levels were low; and that WOW's high inventory levels necessitated significantly higher reserves for charge-offs.

F. Defendants failed to make accurate and thorough disclosures regarding the Company's sales and earnings for the months of April and May, 1987 and for the first quarter of WOW's fiscal year 1988 ending June 30, 1987.

G. Defendants failed to make accurate and thorough disclosures regarding the terms of certain large sales transactions with extended payment terms for which revenue was recognized in the fourth quarter of WOW's 1987 fiscal year; whether such transactions were typical or common in the toy industry; and the effect of such transactions on sales and customer demand in subsequent periods.

H. Defendants failed to disclose that WOW was not a "going concern"; that its financial resources were

inadequate to support operations; and that there was no reasonable basis for the representation that the Company's resources were sufficient to meet its capital needs through March 31, 1988.

I. Defendants failed to disclose that some of WOW's customers:

(1) had rights of return of non-defective products;

(2) had rights of cancellation of orders after shipment; and/or

(3) had been extended price protection with respect to WOW products;

for which appropriate and sufficient reserves had not been taken; and that a material portion of WOW's accounts receivable were uncollectible.

J. Defendants failed to disclose that WOW's National Merchandising Program did not materially increase the Company's access to "sell-through" information from retailers regarding WOW's products, and that the Company's access to "sell-through" information was unsystematic, incomplete and unreliable.

11. I also understand that plaintiffs have alleged that certain defendants sold stock while in possession of undisclosed adverse information which would have been material to an investor, including, some or all of the information set forth in subparagraphs A-J.

12. I have been asked to assume, as plaintiff alleges, that points A., B. and C. (in so far as it relates to the financial statements for fiscal year 1986) were known by defendants prior to the beginning of the Class Period and should have been disclosed at that time. It is also my understanding, that the remaining alleged nondisclosures

were known to defendants prior to the effective date of the 1987 Prospectus and should have been disclosed at that time.

13. On November 9, 1987, Worlds of Wonder reported a net loss of $43 million or $1.87 per share, which included a special charge of $29.8 million for reserves for charge-offs related to product price reductions and disposal of excess materials. On December 21, 1987, WOW filed for protection under Chapter 11 Bankruptcy, after which time investigations were conducted by, among others, the accounting firm of Ernst & Whinney and the investment banking firm of Bear, Stearns & Co., which uncovered additional deficiencies with respect to accounts receivable, charge-backs and adjustments to customer accounts which were improperly recorded. In the third quarter of fiscal 1988 ending December 31, 1987, WOW was forced to take massive reserves and asset write-downs which caused WOW to report a loss of $129 million or $5.62 per share.

HOW THE MARKET PROCESSES INFORMATION TO DETERMINE SECURITY PRICES

14. The securities marketplace sets a fair price for the securities of companies traded in that market by absorbing and reacting to the publicly available information about such companies. Accordingly, it is appropriate and reasonable to speak of the market as a whole as having been misled when material misstatements or material omissions are made about the company's business.

15. It is my opinion that management's statements to analysts and investors are one of the primary sources of information to the market regarding the Company. Any comment made by management is evaluated thoroughly, given greater weight than the myriad of opinions being dispensed by other market participants, and assumed to be accurate. It is generally assumed by analysts that prudent company managers recognize the importance of statements made to the investment community, including financial reports filed with the SEC. Prudent managers also concern themselves with maintaining their credibility with the financial and investment community.

16. Furthermore, it is generally assumed by securities analysts and the investing public that management recognizes its legal responsibilities when making public disclosures and public filings. Investors and analysts expect that they will not be misled directly, or by the obvious inferences to be derived by management's statements.

OVERALL CONCLUSIONS OF MY ANALYSIS

17. Based upon an extensive review of the publicly available documents and my professional experience, it is my opinion that had defendants disclosed at, or any time prior to, June 20, 1986, that the Company did not have the proper internal controls in place to sustain its growth and development, and that the product defect and customer return rates on Teddy Ruxpin, WOW's premier product at the time, were significantly higher than those actually disclosed in the June 1986 Prospectus, the total mix of

information available to the investing public would have been materially altered and WOW's stock price would have declined significantly.

18. In the Spring of 1987, Worlds of Wonder was planning to raise additional capital through a convertible debenture offering. The funds received from the debenture offering were critical to the viability of the Company because it had negative cash flow from operations, was falling far short of internal revenue projections, had stretched out payments to its creditors in anticipation of the offering, and had borrowed to the limit on its bank lines of credit. It is my opinion that had defendants disclosed at, or any time prior to, June 4, 1987 the true operational and financial condition of the Company as alleged by plaintiffs, the likelihood of completing a public debt offering would have been greatly reduced, and in fact may have been an impossibility. Any shortfall in the amount of funds generated by the offering, or the complete failure of the debenture offering, would have expedited WOW's ultimate restructuring or demise. This information would have been deemed material by the investment community as it would have altered the total mix of information regarding WOW's future business prospects and caused investors to seriously question the likelihood that Worlds of Wonder would remain a going concern. Such disclosures would have caused WOW's stock price to decline as it did following the November 9, 1987 Press Release which disclosed WOW's $43 million loss for the second fiscal quarter, which included $29.8 million charge related to reserves for excess inventory and product price reductions.

REVIEW OF WESTERFIELD DECLARATION

Defendants Failed to Disclose Material Adverse Information

19. Based on information communicated to me by plaintiffs' counsel and the evidence reviewed thus far, it is my opinion that the operating and financial risks of Worlds of Wonder were understated and that defendants failed to disclose material adverse facts about the Company. The Westerfield declaration presumes that Worlds of Wonder fell victim to unforeseeable misfortune, or just plain "bad luck", for which defendants assume no responsibility. Investors rely on representations made by management when deciding whether or not to participate in a new equity or debt offering or to purchase or sell securities in the open market. Representations with regard to the Company's historical financial results and current financial condition, including the adequacy of internal accounting and financial controls, form the foundation of information relied upon by investors. Misrepresenting or concealing such information has nothing to do with unforeseen events or bad luck.

20. Defendants' nondisclosure of material facts and overly optimistic statements misled the market with respect to the degree by which WOW was influenced by the risks inherent in the toy industry and risks specific to WOW's financial condition. Investors analyze the relative risk of securities in determining securities prices. It is my opinion that purchasers of Worlds of Wonder's securities were never accurately informed as to the degree of risk inherent in those securities. This is evidenced by the fact that i) defendants consistently issued statements which

minimized the risks with regard to WOW's financial condition and future prospects; and ii) the securities analysts, with management's guidance, analyzed the known risks, and recommended purchasing WOW's stock in light of the known risks.

A. The Westerfield Declaration claimed that WOW's narrow product mix made it vulnerable to lower than expected demand, however, Worlds of Wonder continually announced the expansion of product lines and promised new products in order to allay fears that WOW was reliant on a single product.

> *Some analysts have expressed skepticism that Worlds of Wonder may be too reliant on a single product. Kingsborough told Dow Jones the company plans to introduce six new products for the Christmas retail season.*
>
> *There needs to be a definable player in the industry, but none of the majors [toy companies] are positioned to do that, and we are.*
>
> *(Kingsborough) The Wall Street Journal/Dow Jones Newswire 7/25/86*
>
> *. . . new products, combined with our existing lines, have Worlds of Wonder well-positioned for continued long-term success.*
>
> *(Kingsborough) Third Quarter Report 12/31/86*
>
> *What we're doing definitely isn't dependent on one big hit. With a broad line of products directed at kids, children and teenagers, it will get us away from a lot of the volatility in this [toy] business (emphasis added)."*
>
> *(Stein) The Wall Street Journal/Dow Jones Newswire 3/16/87*

It looks like Julie can do almost as much (in sales) as Teddy did in the first year of business.

(Kingsborough) San Jose Mercury News 04/28/87

B. The Westerfield Declaration claimed the toy industry was fiercely competitive, however statements made by defendants during the Class Period were contradictory.

Because the major toy companies don't know anything about electronics, I'm not at all concerned with the competition: they're all just variations of the Teddy Ruxpin concept (emphasis added).

(Kingsborough) Advertising Age 9/16/86

Product innovation, quality, product identity through marketing and promotion, and strong distribution capabilities are all important elements of competition in these industries. The Company believes it compares favorably with other companies on these factors.

WOW Prospectus 6/4/87

C. Defendants repeatedly stated that Worlds of Wonder had a sound reputation for high quality manufacturing and distribution of its product lines and that this would lead them to future profitability.

Our employees, suppliers, manufacturers' representatives and retailers have all pulled with us. They've helped us to create the most imaginative toys a child can want, to make the best quality toys a parent can buy, and to deliver them to the market at a time and price that would ensure our success.

(Kingsborough) 1987 Annual Report

We're extremely gratified with our Company's strong financial performance in its second year. Even more

importantly, however, we're looking to the long-term future with a corporate strategy of diversification to sustain our success.

(Kingsborough) Press Release 05/15/87

In the 1987 Annual Report, Kingsborough listed several "milestone achievements, including: "Starting a program in late 1986, and continuing it in 1987, to improve our manufacturing, product quality assurance and delivery-to-retail systems." In fact, inadequate internal controls undermined their announced strategy of growth through product diversification. In contrast to defendants' representations, retailers were dissatisfied with delayed receipt of products and WOW experienced high product return rates due to poor quality.

. . . It also has had problems delivering products to dealers in time and in working order.

The Wall Street Journal, 11/10/87

Richard Brady, executive vice president of Play Co., a Southern California toystore chain, is less enthusiastic about Mr. Kingsborough's prides and joys. He says sales of older WOW toys are slowing and adds that every product Play Co. has ordered from WOW has been delivered late.

The Wall Street Journal, 10/28/87

Despite the positive statements previously issued by defendants which were designed to minimize any association with negative industry characteristics, in the August 7, 1987 Press Release, Kingsborough stated that the reduction in workforce and cost containment strategies were being formulated in light of the poor environment for the toy industry. It is my opinion that Company

specific factors were the inherent cause of the decline in WOW's securities prices, despite the less than commendatory performance of some of the other toy industry players in 1987.

21. Defendants diluted the effect of partial disclosures of adverse information about the Company by countering those announcements with positive news or projections, thus maintaining WOW's securities' prices at artificially high levels.

A. Worlds of Wonder issued a press release on May 15, 1987, which announced less than favorable results for the fourth quarter of fiscal 1987 which WOW attributed to "increase in personnel and to substantial investment" in product development. Because the debenture offering was in the works, WOW did not disclose negative developments affecting the Company, but instead, tempered the announcement by saying, "These investments are being made to *insure that Worlds of Wonder continues to grow and be profitable* in the future." (emphasis added) In a presentation to analysts just prior to the earnings release, defendant Stein stated, "When looking at our fourth quarter it is important to know that it is generally a seasonally weak quarter in the toy business because it follows the Christmas buying season." Plaintiffs allege that the financial statements for the fourth quarter of fiscal 1987 were false and should have shown a substantial loss.

B. On July 27, 1987, WOW issued a press release which reported a $10 million loss for the first quarter of fiscal 1988. WOW's stock price fell 9.76% in one day. In order to stem the decline, Kingsborough

falsely reassured the market that first quarter performance was "certainly not indicative of sales expectations for the year" and that the first quarter is "traditionally" a loss quarter for the Company.

C. On August 7, 1987, WOW issued a press release which disclosed that WOW was reducing its workforce by 15% and taking additional cost cutting measures. This type of information typically would have alerted investors that the company might be experiencing cash flow difficulties. Instead, Kingsborough told the investment community that he was "optimistic" that fiscal 1988 sales would be above the prior year's sales; that receivables and inventories were at "manageable levels"; and described the current shortage of cash as "typical" and "seasonal". He also said that the reason he was making the announcement was to "allay fears in the financial community" generated by "untrue and vicious rumors" about the company's prospects.

Investors Were Not Apprised of Many of the Risks Associated With Investing in Worlds of Wonder's Securities

22. The Westerfield Declaration claims an abundance of negative analyst reports and news articles sufficiently alerted potential investors of the risks associated with investing in WOW's securities. Based on my review of more than 30 research reports by professional securities analysts and several hundred news articles published in the general and financial press, it is my opinion that while there were a few skeptical reports disseminated, the majority of analysts and industry observers were bullish on WOW's future prospects. The investment

banking firm known to have had the closest relationship with the Company, Smith Barney, issued positive research reports and advised investors to purchase WOW's stock throughout the Class Period, as late as August 14, 1987.

23. Further, Westerfield concludes that "it is clear from the analysts' reports and the public press that the market's assessment of WOW's prospects in 1987 was not the rosy picture painted by plaintiffs . . . ". He draws this conclusion by taking sentences out of context rather than looking at the analysts' overall opinions and purchase recommendations, which were consistent with the "rosy picture" defendants painted for the market. The Westerfield Declaration fails to capture the analysts' sentiment regarding WOW by selectively quoting any cautionary language regarding the risks inherent in the toy industry from the analysts' reports.

A. Of the Davis, Skaggs Research report dated 8/25/86, the Westerfield Declaration emphasizes the seasonality of the toy business and that most toys have a short product life cycle. However, the analyst also stated the following opinion with regard to prospects for the toy industry in general and for WOW:

> *Demographic trends favor the toy industry. The U.S. is experiencing a "baby boomlet" as the post-war baby boomers reach prime child-bearing age.*
>
> *We project continued growth in Fiscal 1987 sales and profits to $330 million and $31 million. Fiscal 1988 sales are difficult to predict, but based on WOWI's skill at new product introductions, and carry-over demand for existing lines, we project sales of $500 million, and earnings of $2.00/share. As dramatic as these numbers are, we feel they are conservative.*

> *WOWI intends to be more than just a toy company, and really cannot be adequately compared to other companies that product* [sic] *toys alone.*
>
> *By diversifying its product offerings, the company seeks to reduce the volatility and seasonality of toy sales. This should enable the company to command a higher multiple than the typical toy company.*

B. Westerfield quotes from a Dean Witter research report dated 9/22/86 which says, "The toy industry is a highly competitive and notoriously fickle and faddish business," and that WOW's "future depends heavily on management's ability to roll out" successful new products. Westerfield omits the recommendation with regard to WOW, which states, "Keeping these risks in mind, we suggest Worlds of Wonder as an attractive – although speculative – investment over the next 12 – 18 months."

C. The Westerfield Declaration included a quote from the FRC Special Situations Letter dated 7/4/86:

> *The stock market is sure to give these shares a volatile ride, due to the unknowables inherent to Worlds of Wonder's situation.*

However, the thrust of the analyst's recommendation was omitted:

> *Provided our expectations are generally in the ball-park, however, these shares have a realistic shot at reaching $50 a share . . .*
>
> *We think W-W (WOW) is going to have a big year in fiscal 1986, and an even bigger one in 1987.*

D. The following are excerpts from analysts' reports which demonstrate that industry followers with direct access to WOW management, were predicting positive developments at the Company:

> *Major joint development agreements have recently been signed . . . These agreements should be just the tip of the iceberg for WOWI as it continues to expand and diversify its line, and serve to legitimize the company to those investors who might otherwise feel it is only a passing 'fad.'*
>
> *Davis, Skaggs Research, 08/25/86*
>
> *With the successful conception, creation, and marketing of the highly popular Teddy Ruxpin animated toy in the first year of its existence, Worlds of Wonder appears to be well on the way to develop into a major supplier of innovative toys and, eventually, of other consumer products.*
>
> *Dean Witter, 09/22/86*
>
> *. . . it would appear that the company is not only capable of developing a stream of interesting products, but is more than capable of stimulating demand necessary to assure their success.*
>
> *Smith Barney 09/23/86*
>
> *Worlds of Wonder is a unique company with explosive sales and earnings potential . . . The firm has proven itself proficient at quickly developing and delivering sophisticated products, with considerable marketing skills . . . The firm's management has the experience and creativity to successfully direct this rapid growth into the future.*
>
> *L. H. Alton & Company, 10/10/86*
>
> *Although we are now in a seasonally slow period, WOWI's sales should, in particular, benefit from a*

strong demand for (i) Lazer Tag, a product still in its early growth stage that is being positioned as a year round game, and (ii) the availability of new animated plush toys (primarily Mickey Mouse and Mother Goose)."

Smith Barney, 01/29/87

Following end of toy fair and meetings with mgmt. continue to feel quite positive about intermed and long term outlook for WOWI and think the pieces are in place for co to achieve rapid sales and earnings growth not only in FY 88 but also in FY 89 and beyond.

Dean Witter, February 19, 1987

The company has transformed itself from a very profitable purveyor of a few products into a broad based toy manufacturer . . . we believe it has propelled the company into the big leagues with Hasbro, Mattel and Kenner/Tonka, as opposed to other toy companies without any large ongoing earnings base. This should not only benefit the earnings of the company but the P/E ratio as well.

L. F. Rothschild, 09/9/87

Our view is that: (a) the company's product line remains attractive overall (despite some shortfalls from earlier sales assumptions); (b) management is clearly talented in terms of product creativity and marketing; and (c) the company's structure, with a high proportion of variable rather than fixed costs, should enable management to adjust expenses sufficiently to restore profitability.

Smith Barney, August 14, 1987

24. With regard to industry sentiment, the Westerfield Declaration situates itself on both sides of the fence.

First, the declaration claims that "the uncertainties and potential problems in the industry in general, and for WOW in particular, were well recognized by the market." Westerfield extracts cautionary statements from analysts' reports and news articles to support the notion that investors were amply warned as to the risks associated with WOW's securities. This is the predominant theme on pages 6 through 11 of the declaration. Beginning on the bottom of page 11, Westerfield uses the very same industry analysts, who he claims were negative on the Company, to justify the optimistic projections disseminated by defendants. The declaration reads, "Going into 1987, WOW had reason to be optimistic. The company had developed and introduced a number of new products, and analysts applauded WOW's move to diversify." Despite Westerfield's assumption that defendants were entitled to rely on the industry's positive reception of Worlds of Wonder in making their bullish projections, investors some how should have relied on the cautionary statements of selected industry participants when making investment decisions. The myriad of opinions, projections, and information being disseminated to the investing public during the Class Period caused investors to place greater reliance on representations made by defendants which were predominantly bullish during the Class Period.

Worlds of Wonder's Stock Price Responded to Disclosures Associated With Previously Undisclosed Adverse Information

25. The Westerfield Declaration erroneously concludes that there were no material stock price movements

associated with allegedly false or omitted information about WOW. First, Westerfield incorrectly looks at the daily, absolute dollar price changes in WOW's stock rather than percentage price changes. In order to compare apples to apples, one must look at percentage price changes in order to quantify the effect of new information on the stock price. For the most part, stock prices change daily, and a $1 decline in price when the stock is selling for $20 per share is going to be less significant than a $1 decline when the stock is selling for $5 per share. It is evident that Westerfield's methodology of using absolute rather than percentage changes erroneously skews the significant movement toward days when the stock price is relatively higher. In fact, 19 of the "top" 21 price movements as identified by the Westerfield methodology occur in calendar year 1986, when the stock price is above $18 per share. It is simply illogical, and also incorrect, to conclude, as Westerfield does, that the 20% stock price decline which resulted from the November 9, 1987 earnings announcement is not a "material negative" reaction to previously undisclosed information regarding allegations presented by plaintiffs.

26. During the Class Period, the stock behaves as one would expect following the release of either positive or negative information regarding the sales and profit outlook for the Company.

A. A press release was issued on January 26, 1987 which announced earnings per share of $.67 for the third quarter of fiscal 1987. Analysts had been expecting $.80 per share. The stock price declined 8% in one day, falling from $22.25 to $20.50. Had defendants disclosed that Worlds of Wonder had begun extending payment

terms to customers and had improperly booked revenues, in my opinion, WOW's stock price would have declined further.

B. On July 14, 1987, Smith Barney issued a research report which disclosed WOW's lagging Lazer Tag sales and product shipment delays. The analyst lowered his earnings estimate for the first quarter of fiscal 1988 from a loss of $.25 per share to a loss of $.40 per share. WOW's stock price fell 12% in one day, from $12.50 to $11.00 per share. When WOW reported its actual results, a loss of $.45 per share, on July 27, 1987, the stock fell almost 10%, declining from $10.25 to $9.25 per share in one day.

C. On October 28, 1987, the *Wall Street Journal* published an article on WOW partially disclosing the acute problems being experienced by key retailers of WOW's products, namely that sales of older toys were slowing and that product deliveries had been persistently late. The article questioned management's credibility and reported that Wall Street analysts said managements earnings projections had been too optimistic. WOW's stock price fell almost 17% in one day, declining from $3.75 to $3.125 per share.

D. On November 9, 1987, WOW announced a $43 million loss ($1.87 per share) for the second quarter of fiscal 1987. The loss included significant charges for reserves due to product price reductions and excess inventory. WOW's stock price lost 20% of its value in one day, falling from $2.50 to $2.00 per share.

27. The Westerfield Declaration attributes the overall decline in Worlds of Wonder's stock price during the

Class Period to "the myriad of industry-wide problems" affecting WOW and the toy industry in general. However, that conclusion is unsupported by the evidence because Westerfield measures the decline in the stock price of WOW and its competitors over a period of time which *included* the October 19, 1987 stock market crash. In fact, an equally weighted index of the 8 toy industry peers listed in the 8/25/86 Davis, Skaggs Research Report declined just 14% between June 20, 1986 and October 15, 1987, while *WOW's stock price declined 76%*. The S&P 500 index was up 20% for the same period. Clearly, WOW's problems were far greater than those being experienced by the average participant in the toy industry.

28. The Westerfield Declaration measures the decline in WOW's stock price between 10/15/87 and 10/31/87 and erroneously concludes that "WOW lost half its value during the October 1987 stock market crash." It fails to indicate, however, that WOW released material adverse information during October which also had a negative influence on WOW's stock price and should be treated separately from the effect of the market crash. For example, on October 16, 1987 WOW disclosed that it was taking additional measures to reduce costs and was reducing its workforce by an additional 17%. This announcement caused WOW's stock price to decline in excess of the industry and the overall stock market, falling 9% in one day from $6.875 to $6.25. On October 28, 1987, a *Wall Street Journal* report was published which said WOW was experiencing delivery problems and alienating key retailers. It also said that management of WOW had a serious credibility problem with Wall Street observers who said management was overly optimistic in

making earnings projections. In one day, WOW's stock fell 17% from $3.75 to $3.125 while the peer index declined only 4% and the S&P 500 Index was flat. These and other *company specific* announcements contributed significantly to the October 1987 decline in WOW's stock price. In fact, on October 19, 1987, WOW's stock price declined less than either the peer index or the S&P 500 Index, falling 16% versus 19% and 20% respectively.

29. Finally, Westerfield concludes that investors were fairly warned of the risks associated with the debentures issued in June 1987 because the S&P and Moody's bond ratings reflected these risks. This is inherently untrue. Just prior to the offering, defendants made the following remarks to investors at a conference in New York:

> *Now we're well on the way to achieving our plan and goal from the very beginning – that of being a consumer products company with segmented, multilevel marketing orientation and year-around sales of a complete line of quality merchandise . . .*
>
> *. . . we anticipate continued success for our existing lines, including Teddy Ruxpin and his friends, as well as Lazer Tag.*
>
> *It looks like we have a chance at achieving $500 million in sales and perhaps another double of earnings per share in the $1.50 to $1.60 range.*

Had Standard & Poor's and Moody's been fully informed as to the true financial condition of WOW, namely that once the Company used the proceeds of the bond offering to pay down bank debt it would not be able to fund continuing operations; that the Company had uncollectible accounts receivable; and that it had overstated its

previously reported revenues and net income for fiscal 1987, the bonds would have garnered a more speculative rating and may not have been issuable at all. In my opinion, when a B or B3 rated bond defaults within 5 months of the offering, it is usually indicative of serious financial problems which existed at the time of the offering and were undisclosed to the market.

Review of Stillman Declaration

30. I disagree with the conclusion presented by Stillman that there was "absolutely no correlation between any significant negative returns on WOW common stock in the period from June 4, 1987 through November 9, 1987 and any new information relating to fiscal 1987 or WOW's fiscal 1987 financial results." Plaintiffs allege that the results for WOW's fourth quarter fiscal 1987 and the audited results for the full fiscal year 1987, which were published in the Propectus dated June 4, 1987, showed revenue inflated by at least $40 million (against reported revenue of $327 million) and that net income was inflated by at least $15 million (against reported net income of $18.6 million). During the period June 4, 1987 through November 9, 1987, there was no fully corrective disclosure with respect to the fiscal 1987 audit. However, there were a number of partial disclosures of financial and operating problems, which existed in fiscal 1987 and should have been disclosed in the audited financial statements for fiscal 1987, which did cause a decline in the prices of Worlds of Wonder's securities.

31. Furthermore, it is my opinion that any buyer of either the common stock or the 9% convertible subordinated debentures of Worlds of Wonder, Inc., subsequent to the release of the fiscal 1987 audited statements, substantially overpaid for his securities. If the audited statements had revealed sales of at least $40 million less than actually reported, and net income of at least $15 million less than actually reported, investors would have known some of the major problems being experienced by the Company and the securities prices would have reflected that knowledge and been priced much lower. Since the debentures were issued after the audited fiscal 1987 financials were released, and were difficult to sell even with the benefit of the false financials behind them, it is my opinion that had the audited financials been stated accurately, Worlds of Wonder would not have been able to issue the debentures with the same pricing terms and conditions, and probably would not have been able to sell them at all.

32. Finally, Stillman's analysis is further called into question by the fact that he has failed to adequately analyze the available public literature on Worlds of Wonder during the Class Period. This is evidenced by the fact that he identifies at least 5 days of "significant" stock movements for which his Exhibit 1 fails to attribute an explanation. This is discussed further below.

Partial Disclosures

33. The following are examples of partial disclosures with regard to Worlds of Wonder's financial condition which caused a negative reaction in the price of

WOW's securities between June 4, 1987 and November 9, 1987:

A. On July 14, 1987 Smith Barney issued a research report which alerted the market to the possibility that WOW's financial results for the first fiscal quarter ended June 30, 1987 would not meet analysts' expectations. The potential shortfall was attributed to, among other things, shipment delays of new product because of poor quality and excess Lazer Tag inventories due to sluggish sales. It also discussed the effect of WOW's aggressive sales incentives in the March quarter on the June quarter's sales. The information discussed in the research report relates to allegations made by plaintiffs regarding revenue overstatement, failure to record adequate reserves for inventory and receivables, and the effect of sales with extended payment terms on subsequent periods. The market reacted by driving WOW's stock price down from $12.50 per share on July 13 to $11.00 per share on the 14th, a 12% one-day decline.

B. On July 27, 1987, WOW reported a $10 million loss for the first quarter of fiscal 1988 ended June 30, 1987. The loss was attributed to later than expected introduction of new product lines, as well as the cautious stance of retailers toward purchasing new inventory. WOW's stock price declined 10%, falling from $10.25 to $9.25 in one day.

C. On October 16, 1987, WOW announced that it had fired 17% of its workforce, including its chief financial officer, Richard Stein, and its treasurer, Jane Sienes. WOW reported that the additional reduction in its workforce was being implemented as a result of drastic

cost-cutting measures, which was contrary to defendants' prior statement that the cash flow shortage was "seasonal". WOW's stock price declined 9% in one day, falling from $6.875 to $6.25. These disclosures relate to plaintiffs' allegations that WOW's lack of internal financial and accounting controls led to the improper recording of revenue, inventory, and receivables, which ultimately led to WOW's financial crisis.

D. On November 9, 1987, which marks the end of plaintiffs' Class Period, WOW reported a $43 million loss for the second quarter of fiscal 1988 ended September 30, 1987, including a charge of nearly $30 million for a reserve for expenses due to product price reductions and excess inventories. WOW also revealed that it was pursuing alternative financing arrangements in light of its severe shortage of cash and that it would "probably" report a loss for the year. Following the announcement, WOW's stock price declined by 20%, reflecting the market's belief that WOW would not continue as a going concern. This disclosure directly relates to plaintiffs' allegations that WOW misled investors with regard to its financial condition and prospects for the future.

34. It is my opinion that the above negative stock price behavior occurred as a result of the revelation of adverse financial information regarding Worlds of Wonder, and that to the extent that such problems existed during fiscal 1987, as alleged by plaintiffs, and were disclosed on a timely basis, WOW's securities prices would have responded in a similar manner.

The Effect of the Audited Fiscal 1987 Financial Statements

35. The securities analysts who were following Worlds of Wonder and issuing research reports on the stock expected to see successful product development and earnings growth. In fact, the analysts were expecting fiscal 1987 earnings per share in the $.85 – $1.00 range prior to the release of the audited fiscal 1987 financials. It is my experience that negative earnings surprises cause substantial declines in securities prices, therefore, had Worlds of Wonder accurately reported its adverse financial results for fiscal 1987, rather than reporting inflated earnings of $.85 per share, WOW's stock price would have declined significantly.

36. The audited fiscal 1987 financial statements were crucial to WOW's June 1987 debenture offering. Potential investors were especially concerned with WOW's sequential year over year revenue and earnings growth and had WOW's financial results come in below expectations, the terms of the offering would have been materially different, and the price of the debentures would have been materially lower.

Analysis of the Literature

37. For many of the days identified by Stillman as being "significant", he fails to find any information which might explain the stock price behavior, when if fact, the movement can be explained by the public literature. For example, Stillman notes significant price movement on the following dates:

Date	Percentage Price Change
October 9, 1986	+9.52%
November 20, 1986	+6.45%
January 30, 1987	+11.39%
July 14, 1987	-12.00%
August 10, 1987	+12.07%

However, Stillman fails to note the corresponding events which account for the price movements; they are:

(1) October 9, 1986 – The press release regarding the Audec licensing agreement was issued *after the close of the market* on October 8th, therefore the positive price movement occurs on the 9th.

(2) November 20, 1986 – The positive price movement can be attributed to a *Wall Street Journal* article which states that WOW's Lazer Tag product was in high demand.

(3) January 30, 1987 – The positive price movement corresponds with the publication of a Smith Barney research report which touted WOW's sales and earnings growth and recommended investors buy the stock.

(4) July 14, 1987 – The negative price movement can be attributed to the publication of a Smith Barney research report which indicated that first quarter earnings may be below analysts' expectations.

(5) August 10, 1987 – The positive price movement can be attributed to Kingsborough's statements in a *Wall Street Journal* article that WOW's sales in fiscal 1988 will top last years and that the company will be profitable for the year.

38. The conclusions drawn by Stillman are not relevant to the question of whether or not the fiscal 1987 financials caused the stock price for WOW to be artificially inflated. Since plaintiffs allege that WOW's fiscal

1987 financial statements were false, and that such false statements were never fully corrected during the Class Period, it is not possible to observe a stock price reaction to the fully corrected statements. Stillman fails to address how the market *would have* reacted had the financial results for fiscal 1987 been correctly reported, that is, showing revenues and net income substantially below what was reported by defendants.

I declare under penalty of perjury that the foregoing is true and correct and that this declaration was made at Princeton, New Jersey on October 25, 1992.

/s/ John B. Torkelsen
JOHN B. TORKELSEN

DAVID B. GOLD,
A PROFESSIONAL LAW CORPORATION
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UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF CALIFORNIA

IN RE WORLDS OF WONDER SECURITIES LITIGATION	Master File No. C-87-5491 SC Class Action
This Document Relates To: ALL ACTIONS.	**DECLARATION OF ARTHUR S. AINSBERG** (Filed Oct. 27, 1992)

I, Arthur S. Ainsberg, declare:

I.

QUALIFICATIONS

1. I am a partner in the firm of Richard A. Eisner & Company, C.P.A.'s. I am a partner in Eisner's litigation support department, with specific expertise and responsibilities for our business valuations practice, damages analysis sector, and corporate finance activities, including

significant involvement in merger and acquisition transactions, due diligence responsibilities and capital commitment duties. I have been a senior officer at two major investment banking organizations, and have been retained in over forty assignments to provide my business judgment on the valuation aspects of significant publicly announced corporate merger transactions. The aggregate valuation of these transactions exceeds $100 billion. I have also provided expert or consulting services in connection with shareholder litigation for more than five years. My resume is attached hereto as Exhibit 1.

2. I have been retained by Plaintiffs' counsel in this litigation to review available information regarding Worlds of Wonder, Inc. ("WOW" or the "Company") in connection with the period from June 20, 1986 through November 9, 1987 and to provide a Declaration concerning my findings relating to the due diligence activities conducted by Smith Barney, Harris Upham & Co. ("Smith Barney") at the time of WOW's public offering of $80 million of 9% Convertible Subordinated Debentures due 2012 (the "Debentures") on June 4, 1987 (the "Offering") and the disclosures contained in the final prospectus issued on that date in connection with the Offering. In order to provide the information which is contained in this Declaration, I have reviewed a significant amount of both public and nonpublic information that has been provided to me by counsel.

3. Over my twenty-five year career, I have been called upon to conduct due diligence in a significant number of potential investments and offerings and have been certified to testify at trial in the United States District Court for the Northern District of California as a due

diligence expert in connection with a public offering of convertible debentures.

II.

OPINION

4. In my opinion, the prospectus filed with the Securities and Exchange Commission (the "SEC") in connection with the Offering of the Debentures (the "Prospectus") contained material misstatements of fact and omitted to state material information making that which was stated misleading. The information which was misstated or omitted would have influenced the investment decision of a potential purchaser of the Debentures at the time of the Offering. It is also my opinion that Smith Barney, the sole underwriter of the Offering, knew or should have known that the Prospectus contained these misstatements and omissions at the time it was conducting its due diligence in connection with the Offering. Finally, it is my opinion that in connection with the Offering, Smith Barney did not conduct a reasonable due diligence investigation under the circumstances and did not have reasonable grounds to believe that the Prospectus was free of material misstatements and omissions.

III.

DOCUMENTS REVIEWED

5. In connection with the preparation of this Declaration, my staff and I have reviewed, among other things, the following documents:

- Depositions and related exhibits of the following individuals:

  Ronald Barrington
  Gerald W. Bodzy
  Mark Bradlee
  Terrance Bruggeman
  Van Butler
  Richard J. Char
  Kathryn Gutierrez
  Stephen Handley
  Judith Haselton
  John Howenstine
  John Kenney
  Dana Ketcham
  Donald Kingsborough
  Robert Latta
  Amy Ludwig
  Kim Maguire
  Kerry Mac Vay (w/o exhibits)
  Barry Margolis
  John Neifing
  Louis Paglia
  Eric Roberts
  Richard Stein
  Douglas Tanner
  James Tindal
  James Lee Whims

- The June 20, 1986 IPO Prospectus;

- The June 4, 1987 Debenture Prospectus;

- Declaration and related exhibits of the following individuals:

  Gerald W. Bodzy
  John Forsythe
  Stephen Handley
  Judith Haselton

Craig Johnson
John Kanberg
Donald Keller
John Kenney
Dana Ketcham
Amy Ludwig
Marco Roggero
Douglas Tanner

- 10-K and 10-Q reports filed by WOW with the SEC during the fiscal years ended March 31, 1986, 1987 and 1988;
- Wall Street analysts' reports on WOW issued during calendar 1986 and 1987;
- Media articles regarding WOW appearing during calendar 1986 and 1987.
- Company press releases from calendar 1986 and 1987.
- February 1988 Information Brochure from Bear, Stearns & Co., Inc.
- May 1987 Presentation Report to Moody's.
- Bankruptcy Court declarations or testimony and related exhibits of the following individuals:

  Fred Fuld, Jr.
  Charles Mayer
  Mike Needleman

- Various exhibits to the depositions of other witnesses deposed in this litigation.

My staff and I have spent in excess of 700 hours reviewing these materials and preparing this Declaration.

IV.

THE PROSPECTUS OMITTED TO DISCLOSE SIGNIFICANT FACTS WHICH COULD HAVE AFFECTED THE INVESTMENT DECISION OF A POTENTIAL PURCHASER OF THE DEBENTURES.

6. In my opinion, the Prospectus omitted to disclose significant facts which could have affected the investment decision of a potential purchaser of the Debentures. These include excessive retailer inventories and low consumer demand; the effect of F.O.B. sales and dated sales; and shifting of expenses during fourth quarter 1987 into 1988; accounts receivable collection problems due to undisclosed terms of sale; and the terms and implications of WOW's significant transaction with K-Mart Corporation ("K-Mart"), WOW's second largest customer, at the end of fiscal 1987. These facts can be substantiated through deposition testimony as well as contemporaneous internal documents and correspondence. Although in some cases these documents were dated subsequent to the Offering date, the conditions which led to their creation were clearly known to their authors in advance of the Offering. I will focus on each of these issues, among others, in greater detail.

7. Based on my review of the deposition testimony and the exhibits, it appears to me that Smith Barney placed too much reliance on representations made by top management of WOW without sufficient independent verification. Although it appears that Smith Barney did speak with members of WOW's middle management, interviews with eight key managers were held in one day. Exh. 96.

8. Proper due diligence requires the verification by the underwriter of the significant information provided to it by Management. Due diligence also involves making sure that all material information required for an investor to make an informed decision about the prospects for the Company be disclosed in the prospectus. In a company such as WOW, which had significant growth during its short life span and which had been primarily fueled by one or two hot products, a measure of extra care was warranted. It is apparent to me from my review of the deposition testimony as well as documentation found in the Company's files, that top management, as well as many of the other employees of WOW, knew of serious problems at the Company during the months leading up to the 1987 Debenture Offering. Particular areas of concern were sales, production, financial controls, cash flow, and inventory accumulation. Each of these problems should have been ascertained, analyzed, and disclosed by the underwriter during the course of the due diligence process. As an example, thorough interviews of the top retail accounts of WOW would have confirmed to the underwriter the accuracy of many other indicators showing the lack of sell-through, high inventory levels at the retail level, special sales terms granted to customers by Management and paperwork problems which led to delayed collection of accounts receivable. "Sell-through" refers to the selling through of a manufacturer's product from the shelves of retailers to the ultimate consumer.

9. The problems discovered during this interview process would then have warranted in-depth interviews with WOW Management, which should have made the

underwriter fully aware of the precarious financial condition of the company in May 1987. In my opinion, with the information the underwriter had, or should have had if it had conducted an appropriate due diligence investigation, the Offering should not have been consummated.

10. The specific items which, in my opinion, the Prospectus failed to disclose are as follows:

Excessive Retailer Inventories and Low Consumer Demand

11. The Prospectus failed to disclose that many of the major customers of WOW during the period from January through May 1987 had excessive inventories of the Company's product and severe difficulties selling those products to consumers.

12. John Forsythe was the Credit and Collections Manager at WOW in 1986 and 1987. In this capacity, he had primary responsibility for collecting amounts due to WOW from its customers. As a daily part of his job, Forsythe and his staff were in constant contact with WOW's customers and were told, first hand, about problems and concerns WOW's customers had which affected the customers' payments allegedly due WOW. Because of his position at WOW, it appears that Forsythe was almost uniquely able to judge WOW's customers' demand for product, to hear about problems regarding billing, credits and shipping, and to learn of "special deals" and concessions which WOW's top management had granted to major customers.

13. WOW's 1988 business plan projected that WOW would sell 1,500,000 units of Lazer Tag. Projected sales of Lazer Tag represented the single largest increase by product in 1988. Exh. 69. The underwriter was well aware of the importance that demand for Lazer Tag played in WOW's ability to meet its 1988 plan. However, Forsythe testified that as early as February 1987 he knew that retailers had excess inventories of unsold Lazer Tag and related kits from speaking to the retailer customers, the manufacturers' sales representatives (the "reps"), and WOW internal sales people. He stated it "was common knowledge among everyone at the Company." Forsythe overheard a conversation at the February 1987 Toy Fair where Jim Whims, WOW Vice President of Sales, and Mark Bradlee, WOW Executive Vice President of Sales, told Donald Kingsborough, WOW Chairman and Chief Executive Officer, that buyers told them that Lazer Tag was a "dead" product. Further, WOW's salesmen were concerned that customers could not sell units of Lazer Tag they already had and doubted they could convince customers to buy any more. Forsythe also testified that he understood from conversations with Bradlee, Whims, the reps and the retailers that the decline in sales in Lazer Tag was not seasonal but rather that the product lacked sufficient "play value" and that consumers' word of mouth on the product was not good. Forsythe Decl., pp. 11-12.

14. Forsythe testified that Toys R Us, Inc. ("Toys R Us") (the Company's largest customer, accounting for 19% of 1987 sales) experienced very slow sell-through at retail of WOW products as early as March 1987. Forsythe Decl., p. 24. He testified that the primary reason that WOW offered "dating" on its products during the forth

quarter of fiscal 1987 was that demand for the product on normal trade terms had declined dramatically by the end of March. Forsythe Decl., p. 19. Forsythe also testified that it was common knowledge among the WOW sales personnel, reps and customers that the demand for Lazer Tag had collapsed after Christmas 1986 and that sell-through was terrible. He stated that the pipelines were stuffed and retailers were severely overstocked and products were not moving. A substantial number of the customers wanted to return excess inventory of Lazer Tag. Forsythe Decl., p. 11.

15. In May 1987, Bradlee received a letter from K-Mart that stated, "Please advise when you think you will be able to sell off the 100,000 pieces of Lazer Tag we discussed at our meeting. We are most anxious to have our total quantity reduced by this amount due to the lack of movement of the 51,000 pieces we currently have on hand." Exh. 97.[1]

16. WOW received a letter in June 1987 from Top Sales Company (a rep) stating "Rose's (a retailer) is very upset with us . . . (and) has a serious overstock of Lazer Tag." Exh. 98.

17. In June 1987, the Company received a memo from Mattel, its European distributor, regarding "rumors in all markets of imminent markdowns and subsequent closeouts of Lazer Tag in the U.S. . . . which will result in Lazer Tag being the 'closeout of the decade'." Exh. 100.

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[1] Exhibit references are to the exhibits attached to the Declaration of Alan R. Plutzik, filed herewith.

18. In June 1987, WOW Regional Sales Manager Carl Crosier received a letter from Brennan & Howard, another rep, which stated that "someone has their head in the sand if they think . . . that product is in demand at this time of year. It is true that merchandise it still selling but not at Christmas time rates . . . We should not have to remind you that we have more than enough inventory already out at retail." A schedule of May inventory and selling rates at Gold Circle (a retailer) reflected inventory in excess of 100 months' sales at the May rate. Exh. 101.

19. In July 1987, Kingsborough received a memo from Ross Heil, a WOW marketing employee, regarding "mounting retailer concerns of slow Lazer Tag movement and their substantial inventories." Exh. 98. An interoffice memo in July 1987 from Dave Ruckert, a WOW employee, to Bob Goldberg, WOW Executive Vice President of Marketing, stated "Target – won't order Lazer Tag extensions until current product starts to sell . . . Circus World – very upset about Lazer Tag." Exh. 98.

20. In July 1987, Kingsborough received a letter from Howard Moore, Executive Vice President of Toys R Us, stating, "This letter is to reiterate the ongoing problems we are both facing on our inventory . . . The Snoopy and Mother Goose tapes are a major problem that will not go away. The Lazer Tag accessories seem hopeless. The Pamela situation has to be addressed for this Christmas as we discussed. We would like to take action on these as soon as possible. Please advise me of your latest thinking on these items so we may incorporate any new prices in our roto advertising." Exh. 99.

21. It is clear that the Company's major customers were having serious difficulties selling WOW's product line during the months leading up to the Debenture Offering. It is equally clear that Management and most of the Company's employees were well aware of these difficulties. Armed with the knowledge that consumer demand for the Company's principal products was falling and that retailers had large inventories of WOW products they could not sell, the underwriter should not have allowed the Offering to proceed. At a minimum, these market conditions should have been disclosed in the Prospectus.

F.O.B. Sales and Dated Sales

22. The Prospectus failed to disclose the reasons that the Company entered into the F.O.B. sales and dated sales transactions at the end of the third and fourth quarters of 1987 and their impact on future sales and profitability. The Prospectus disclosed that:

> "the Company offered a program in late December (1986) which allowed retailers to purchase products in containers F.O.B. Hong Kong. Net sales were approximately $20,000,000 under this program." (p. 11)

The Prospectus also disclosed:

> "as the Company believes is common in the toy industry, the Company offered "dating" on approximately $52,000,000 of fourth quarter sales, extending payment terms to December 1987. Approximately $17,000,000 of such sales were shipped F.O.B. Hong Kong." (p. 11)

23. According to WOW, sales which were "F.O.B. Hong Kong" were sales in which title was transferred to the buyer at the time of shipping from Hong Kong. (See ¶ 81, *infra*) Forsythe testified that it was common knowledge within the Company that the F.O.B. program was a device to generate sales that WOW otherwise would not have made in that quarter. He stated:

> "It was common knowledge within the Company that these transactions were being entered into to pump up reported sales so that WOW could reach its fiscal year-end net revenue target of approximately $330 million, to become the fastest-growing public company in the history of American business.
>
> Within the Company, the common feeling was that the $330 million figure was a target number that we had to hit because WOW had committed to the financial community that it would make that target." (Forsythe Decl., p. 17)

24. "Dated sales" or "dating" is defined as an extension of credit beyond the supplier's customary due date for payment. Forsythe and Baldev Madahar, WOW Controller, warned WOW's top management that the dated sales would result in the pipelines being crammed so full that many of WOW's important customers would not need to order any of the Company's products for months to come. Forsythe Decl., p. 21. In effect, WOW was funneling its fiscal 1988 sales into fiscal 1987.

25. Of the $110,000,000 in net sales recorded during the fourth quarter of 1987, $52,000,000 or 47% were booked under the dated sales program. If the Company had not entered into these dated sales transactions, it

would have reported a substantial loss for the fourth quarter and for the entire fiscal year. In my opinion, WOW would likely not have been able to bring the Debenture Offering to market had it reported a loss in fiscal 1987.

26. Forsythe testified that pushing to " 'make the numbers' for the quarter or fiscal year was *de facto* corporate policy at WOW at the end of each quarter and at the end of each fiscal year beginning at least as early as the end of the fiscal year ended March 31, 1986." Forsythe Decl., p. 9.

27. WOW's sales budget for the fourth quarter was $93 million. *If WOW had not entered into the dated sales transactions or the media barter transactions discussed below during the fourth quarter, its actual sales would have been $49 million, or nearly 50% below budget.* The Offering would not have been possible had WOW reported such a revenue shortfall from Wall Street's expectations.

28. Van Butler, Senior Vice President of Marketing at Toys R Us, WOW's largest customer, testified that he was asked by Whims and Kingsborough to enter into the March 1987 dated sales program because WOW wanted "to ship goods to complete their sales program for the fiscal year." Butler Dep., p. 77.

29. Another reason that the Company entered into the dated sales transactions was to generate sufficient cash to keep operating until the Debenture Offering could be completed. Under its secured line of credit form a syndicate of banks led by First National Bank of Chicago ("First Chicago"), the Company could borrow up to the lesser of $110,000,000 or 75% of "eligible" accounts

receivable. During the period from January through May 1987, the Company routinely borrowed the maximum amount available under the "receivable cap" of its credit line. The cap was always well below the $110 million overall limit. At the same time, as discussed below, WOW's inventory levels were increasing very rapidly and the Company was not collecting sufficient cash from its accounts receivable to pay its bills. Until the Offering could be completed, the only way for the Company to generate substantial amounts of cash was to convert its inventory into "eligible" accounts receivable that could then be borrowed against. The dated sales program provided this mechanism. In March 1987, the Company received a waiver from the First Chicago bank syndicate allowing WOW to treat the receivables from dated sales as "eligible" for borrowing purposes up to a maximum of $45,000,000. Exh. 102. The permission of WOW's lenders was required because under its loan agreement, receivables had to be due within 90 to 120 days of sale in order to be considered eligible. Under the dated sales program, no receivable would be due and payable until December, almost nine months later. Had the Company not entered into these transactions to generate "eligible" receivables, it would have run out of money well in advance of the Debenture Offering.

Shifting of Expenses During Fourth Quarter 1987

30. The Prospectus failed to disclose certain other transactions recorded during the fourth quarter of fiscal 1987, which had the effect of artificially inflating the Company's earnings for that period. In order to cover a $3 million shortfall in the intercompany accounts

between the U.S. and Hong Kong at year-end. Exh. 103. The Company shifted $1.3 million in advertising and $400,000 in other expenses from fiscal 1987 into fiscal 1988. In addition, the Company took back into income approximately $1.3 million in bonuses for Management which it had accrued as expense during the year. Exh. 104.

* * *

Shifting of Expenses During Fourth Quarter 1987

117. Tanner's notes indicate that the shifting of expenses from fiscal 1987 into fiscal 1988 and the reversal of the bonus accrual were discussed with the underwriter prior to the Offering. Smith Barney knew that the $3 million discrepancy in the intercompany accounts existed and that unless $3 million of additional income or reduction in expenses were found, the Company would have to report a loss for the fourth quarter of 1987, making the Debenture Offering difficult if not impossible. Exh. 103 and 104. The underwriter had to know that the sole purpose for engaging in these transactions was to assure that the Company was able barely to report a profit during the fourth quarter. There would have been no other legitimate purpose for these last minute accounting entries.

* * *

I declare under penalty of perjury that the foregoing is true and correct to the best of my knowledge and belief.

Executed this 23rd day of October, 1992, at New York New York.

/s/ Arthur S. Ainsberg
Arthur S. Ainsberg

Sworn to before me on this 23rd
day of October 1992

/s/ Donna M. Adams
Notary Public

DONNA M. ADAMS
Notary Public, State of New York
No. 24-4846182
Qualified in Kings County
Commission Expires November 30, 1993

Exhibit 1

[LOGO]

Arthur S. Ainsberg, CPA, MBA
Partner, Litigation Support Department

PROFESSIONAL EXPERIENCE

LITIGATION support background includes significant experience in the valuation of privately owned and public corporations, white-collar crime, damages analyses, matrimonial equitable distribution issues and representation of claimants in securities arbitration matters. These matters included extensive deposition and trial testimony. Has also been involved in the preparation of extensive affidavits relating to valuation issues.

FORMERLY self-employed in the consulting firm of Ainsberg Associates with clients in the investment banking and securities industries. Conducted extensive forensic accounting analysis.

TWENTY-YEAR securities background in various financial capacities at both public accounting firms and securities investment partnerships/investment banking organizations. Specific expertise in the securities industry including compliance, due diligence, stock options, operations and taxation. In addition, extensive experience in the commodities industry.

SERVED clients in the following industries:

Commodities	Manufacturing
Law Firms	Public Relations
Not-for-Profit Entities	Real Estate Development
Entertainment Entities	Stock Brokerage
Investment Banking	

FORMERLY adjunct professor of accounting, Hunter College, Lehman College and Mercy College.

PUBLICATIONS

AUTHOR of *Bits and Pieces,* a monthly newsletter for investment banking and money management organizations. The newsletter highlights the investment merits of publicly traded spinoff companies.

EMPLOYMENT HISTORY

1991	Richard A. Eisner & Company Partner, Litigation Support Department
1986-1990	Ainsberg Associates President
1984-1986	Marcus Schloss & Company Chief Financial Officer
1979-1984	Odyssey Partners/Oppenheimer & Company Chief Financial Officer (1982-1984) Vice President (1979-1982)
1974-1979	Oppenheim, Appel, Dixon & Company Audit Manager

EDUCATION

MBA – Baruch College, New York City, Finance and Investments, 1972.

BBA – City College of New York, Baruch School of Business, Accounting, 1968.

PROFESSIONAL AFFILIATIONS

MEMBER of the American Institute of CPAs, the New York State Society of CPAs, the Wall Street Tax Association, the Bankruptcy Committee of the New York State Society of CPAs, the Legal and Compliance Division of the Securities Industry Association, the New York Society of Securities Analysts and the American Society of Appraisers.

Declaration of Robert Stillman, ER 450
(exclusive of exhibits)

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UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF CALIFORNIA

IN RE WORLDS OF WONDER SECURITIES LITIGATION	Master File No. C-87-5491-SC
	Class Action
This Document Relates To: ALL ACTIONS.	DECLARATION OF ROBERT STILLMAN IN SUPPORT OF DELOITTE AND TOUCHE'S MOTION FOR SUMMARY JUDGMENT, OR ALTERNATIVELY FOR SUMMARY ADJUDICATION OF CLAIMS
	Date: December 11, 1992 Time: 10:00 a.m. Dept.: Hon. Samuel Conti

I, Dr. Robert Stillman, declare:

1. I am Senior Vice President of Lexecon, Inc., an economic and financial consulting firm. I received an M.Sc. degree in economics from the London School of Economics in 1974 and a Ph.D. in economics from the University of California, Los Angeles in 1980. I have been employed as an economist at Lexecon since 1980. Additional information regarding my background and qualifications are set forth in my resume, attached hereto as Exhibit 1. I would be competent to testify to the facts set forth herein if called upon to do so.

2. I have been retained by attorneys for Deloitte & Touche in this case to perform an analysis of the causes of the decline in value in the publicly traded securities of Worlds of Wonder, Inc. ("WOW") during the period from June 4, 1987 through November 9, 1987, including a review of public information released during that time period. All of the work on this project was done by me personally or by professional economists on the Lexecon staff, under my direct supervision and review.

3. My analysis included examination of press releases, news articles, industry publications, research analyst reports, stock price data and other publicly available information regarding WOW and the toy industry. To gather this data, we performed a search of electronic data bases including Dow Jones News Wire, Nexis and Dialog. We obtained stock price data from the Center for Research in Security Prices ("CRSP") at the University of Chicago. In addition, we requested and obtained analyst reports, press releases and other public documents from counsel for Deloitte & Touche.

4. We found no public disclosures of adverse new information regarding WOW's fiscal 1987 financial statements, dated receivables for fiscal 1987 sales, the 1987 FOB program, the 1987 K-Mart sale, 1987 barter sales, or any other fiscal 1987 accounting issue at any time during the period from June 4, 1987 through November 9, 1987. In fact, we found no public disclosures of *any* new information, adverse *or* positive, regarding those subjects during that time period.

5. We also reviewed the performance of WOW's common stock throughout 1987 in order to obtain an overview of the market's perception of the value of WOW's publicly traded securities during the period from June 4 through November 9. A chart reflecting the performance of WOW's common stock through 1987 is attached hereto as Exhibit 2. That chart shows that, at the time of the June 4 debenture offering, the price of WOW's stock had already been declining steadily and significantly for months. For instance, on the first trading day of 1987, WOW's common stock closed at $20.25 per share, whereas on the day of the debenture offering, WOW's common stock closed at $14 per share, a decline of over 30%. Thus, it was clear that, at the time of the debenture offering, the financial markets perceived WOW's future prospects as weakening, and WOW's publicly traded securities were already experiencing a signficant decline. After the offering, WOW's stock continued to experience a steady decline.

6. In order to examine the causes of the decline in WOW's publicly traded securities, we performed a standard statistical analysis to identify those days during the period from June 4, 1987 through November 9, 1987 on

which the market adjusted returns for WOW's common stock were statistically different from zero. The purpose of this analysis was to identify declines in the price of WOW's stock which were not explainable by market or economy-wide effects. The days on which the market adjusted returns for WOW's common stock were statistically different from zero are show [sic] by the symbol * * * on the Event Study, which is attached hereto as Exhibit 3. The Event Study also shows the closing price of WOW's common stock on each trading day, and includes summaries of public disclosures.

7. Our Events Study shows that during 1987 there were public disclosures on the following subjects: anticipated weak sales in the first quarter of fiscal 1988; slow Lazer Tag sales in fiscal 1988; the absence of new hits in the toy market and lackluster sales in the industry as a whole; WOW's announcement of weak sales and increased expenses in the first quarter of fiscal 1988; increasingly pessimistic securities analyst reports regarding both WOW and the toy industry in general; WOW's announcement in August of a reduction in its workforce and capital expenditures; WOW's October announcement of further cost cutting measures; negative press regarding slow sales of WOW toys, late deliveries, and dissatisfied customers; the lowering of WOW's credit rating in October by Standard & Poor's; and finally the November announcement of large losses in the second quarter of fiscal 1988. The Events Study reveals that certain of these disclosures were correlated with statistically significant negative returns on WOW's common stock.

8. We found absolutely *no* correlation between any significant negative returns on WOW common stock in

the period from June 4, 1987 through November 9, 1987 and any new information relating to fiscal 1987 or WOW's fiscal 1987 financial statements.

I declare under penalty of perjury that the foregoing is true and correct and that this declaration was made at Knoxville, Tennessee on September 18, 1992.

/s/ Robert S. Stillman
Robert Stillman